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In the Supreme Court of the United States

OCTOBER TERM, 1986

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ASPHALT PRODUCTS CO.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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QUESTION PRESENTED

Section 6653(a)(1) of the Internal Revenue Code provides that "[i]f any part of any underpayment * * * of any tax * * * is due to negligence or intentional disregard of rules or regulations," a penalty shall be imposed in "an amount equal to 5 percent of the underpayment." The question presented is whether the court of appeals erred in holding that, under the circumstances of this particular case, the negligence penalty should be computed, not as 5% of the underpayment, as the statute requires, but rather as 5% of the portion of the underpayment that is attributable to the negligence.

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COMMISSIONER OF INTERNAL REVENUE, PETITIONER

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Sixth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-26a) is reported at 799 F.2d 243. The memorandum opinion of the Tax Court (App., *infra*, 31a-81a) is reported at 47 T.C.M. (CCH) 1621.

JURISDICTION

The judgment of the court of appeals (App., *infra*, 27a-28a) was entered on July 17, 1986. The government's petition for rehearing was denied on September 25, 1986 (App., *infra*, 29a-30a). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTE INVOLVED

Section 6653 of the Internal Revenue Code (26 U.S.C.), as in effect in 1974, is set forth in the Appendix, *infra*, 90a-91a.

STATEMENT

Respondent Asphalt Products Company is in the business of manufacturing emulsified asphalt for highways. In 1974, respondent's principal shareholders purchased two trailer-mounted wastewater treatment plants that were temporarily situated in California. The shareholders bought these plants in their individual capacities, for use in a Tennessee development; the plants were completely unrelated to respondent's business as an asphalt manufacturer. At about the same time that the shareholders purchased the trailer-mounted plants, respondent purchased two highway tractors suitable for towing large, heavy trailers. These tractors were used to transport the shareholders' trailer-mounted plants from California to Tennessee. On its income tax return for 1974, respondent claimed a deduction in the amount of $1,103 for the salaries and expenses of the truck drivers who transported the plants across the country. App., *infra*, 3a-4a, 38a-40a.

On audit, the Commissioner determined a deficiency in tax of $154,332 for respondent's 1974 tax year. The bulk of the deficiency was attributable to the Commissioner's determination that respondent had improperly computed its asphalt business income on the cash method of accounting rather than on the accrual method.[1] Of the balance of the deficiency,

[1] Respondent challenged this determination in the Tax Court, but the Commissioner's rejection of respondent's use of the cash method of accounting was sustained by the Tax

approximately $500 was attributable to the Commissioner's disallowance of the $1,103 deduction claimed by respondent for the truck drivers' salaries and expenses, a disallowance predicated on the fact that those costs were not ordinary and necessary expenses incurred in carrying on respondent's business, but rather were incurred for the shareholders' personal benefit. The Commissioner further determined that respondent's claim of a deduction for the truck drivers' salaries and expenses was due to negligence or intentional disregard of IRS rules and regulations. Accordingly, pursuant to Section 6653(a) of the Internal Revenue Code,[2] the Commissioner asserted an "addition to tax," commonly called a "penalty," in "an amount equal to 5 percent of the underpayment" (I.R.C. § 6653(a)(1)). Since the underpayment was in the amount of $154,332, the asserted negligence penalty was in the amount of $7,716. App., *infra*, 3a-4a, 33a.

Respondent sought redetermination of the deficiency in the Tax Court. Respondent stipulated that it had erred in deducting the truck drivers' salaries and expenses (App., *infra*, 34a n.3). But it maintained that it had not been negligent in deducting those expenses and that the negligence penalty therefore should be set aside. The Tax Court rejected that contention, concluded that respondent had indeed been negligent, and upheld the Commissioner's imposition of a penalty (*id.* at 80a). The Tax Court redeter-

Court (App., *infra*, 63a-68a). That aspect of the Tax Court's decision was affirmed on appeal (*id.* at 4a-13a), with one dissent (*id.* at 17a-26a), and is not involved in this petition.

[2] Unless otherwise noted, all statutory references are to the Internal Revenue Code (26 U.S.C.), as amended (the Code or I.R.C.).

mined a deficiency (reflecting other adjustments) in the amount of $133,249 and thus a negligence penalty in the amount of $6,943 (*id.* at 82a-83a).[3]

The court of appeals affirmed the Tax Court's finding that respondent had been negligent in deducting the expenses in question. The court ruled, however, that it would be unduly harsh to subject respondent to a penalty equal to 5% of the entire $133,249 underpayment when only $500 of that underpayment was attributable to negligence. App., *infra*, 13a-15a. Although acknowledging that the Tax Court's computation of the penalty was supported by the language of the statute and the decisions of at least two other circuits (*id.* at 14a), the court of appeals held that, "[u]nder all the circumstances of the instant case," the 5% negligence penalty should be "applied only to that portion of the deficiency attributable to the disallowed deduction" (*id.* at 15a (quotation marks omitted)).

REASONS FOR GRANTING THE PETITION

The decision of the court of appeals is inconsistent with the clear language of Section 6653(a) and with Congress's unequivocal declarations of the intent of that statutory provision. The decision below also conflicts with decisions of other courts of appeals construing Section 6653(a) and the parallel fraud penalty contained in Section 6653(b). If this decision is permitted to stand, it will lead to extensive and

[3] The negligence penalty worked out to slightly more than 5% of the deficiency because of a requirement that the deficiency be adjusted for certain carrybacks (such as net-opertaing-loss and investment-credit carrybacks) before the penalty is computed. See I.R.C. § 6653(c)(1); Resp. Computation for Entry of Decision, Schedule 5 (T.C. June 24, 1984).

burdensome litigation in the Tax Court, to unequal treatment of taxpayers nationwide, and, at least in the Sixth Circuit, to frustration of Congress's intent to deter negligence in the preparation of tax returns.

1. Section 6653(a)(1) of the Code provides that "[i]f any part of any underpayment (as defined in subsection (c)(1)) of any tax * * * is due to negligence or intentional disregard of rules and regulations * * *, there shall be added to the tax an amount *equal to 5 percent of the underpayment*" (emphasis added). Section 6653(c)(1) generally provides that "the term 'underpayment' means * * * a deficiency as defined in [Section 6211]." And Section 6211 defines a "deficiency" as the amount by which the tax actually due exceeds the amount shown as tax on the taxpayer's return. Since the Tax Court determined, and the court of appeals affirmed, a "deficiency" in the amount of $133,249, the statute unambiguously requires that the negligence penalty be computed with reference to that entire amount, as the Tax Court held. Few things in life could be clearer or more certain than this.

If any confirmation of the plain meaning of Section 6653(a)(1) were necessary, it is provided by the following subsection, which was added to the statute in 1981. Section 6653(a)(2) imposes an additional penalty in an amount equal to 50% of the interest that is payable "with respect to *the portion of the underpayment* described in paragraph (1) which is attributable to the negligence" (emphasis added). Thus, Congress quite clearly distinguished between penalties computed on the basis of "the underpayment" and penalties computed on the basis of a "portion of the underpayment." The general 5% negligence penalty lies in the former category, and the

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court of appeals plainly erred in holding to the contrary.

The fact that Section 6653(a)(1) imposes a negligence penalty equal to 5% of the entire underpayment has not heretofore been subject to any doubt. In the 68 years since the negligence penalty was first enacted (Revenue Act of 1918, ch. 18, § 250(b), 40 Stat. 1057), no court, save the court below, has ever held that the penalty applies only to the portion of the underpayment that is attributable to the taxpayer's negligence. Indeed, even respondent in this case did not have the temerity to suggest that the penalty should be so computed, for it limited its argument to the contention that there was no negligence at all. The court of appeals reached that novel result *sua sponte* in an apparent attempt to do what it perceived to be "equity" in the case before it. The court did not attempt to explain how the language of the statute could be construed in this fashion, and the court's decision is thus a clear instance of judicial amendment of the statute that Congress enacted.

2. Congress recently reaffirmed the proper construction of Section 6653(a)(1) during its deliberations over the Tax Reform Act of 1986. As described in the Conference Report on that statute (2 H.R. Conf. Rep. 99-841, 99th Cong., 2d Sess. 779-783 (1986), reprinted at App., *infra*, 84a-89a), Congress gave detailed consideration to whether the scheme for imposing negligence and fraud penalties should be changed—in particular, the requirement that the penalty be based on the entire amount of the underpayment. Section 6653(b) of the Code has long provided for a fraud penalty essentially parallel to the negligence penalty set forth in Section 6653(a); prior to amendment by the 1986 Act, the fraud penalty was imposed in "an amount equal to 50 percent of the

underpayment" if "any part of [the] underpayment * * * is due to fraud." The House Bill proposed increasing the fraud penalty to 75% and limiting it to the portion of the underpayment specifically attributable to the fraud. The Senate Amendment proposed increasing the negligence penalty to 10% and similarly limiting it to that portion of the underpayment attributable to the negligence. Although the fraud penalty was amended in this fashion, the Conference rejected the Senate's proposed amendment of the negligence penalty and decided to "maintain[ ] the 5-percent rate of present law, and the present-law application of that penalty to the entire amount of the underpayment, not just to the portion of the underpayment attributable to negligence" (2 H.R. Conf. Rep. 99-841, *supra*, at 782; App., *infra*, 88a (footnote omitted)).

The Conference Report went on to address the decision of the court of appeals in the instant case, which had been rendered two months earlier. The Report stated (2 H.R. Conf. Rep. 99-841, *supra*, at 782 n.3; App., *infra*, 89a n.3):

> In a recent case, the Sixth Circuit held that the negligence penalty "should be applied only to that portion of the deficiency attributable to [the negligent action]." (*Asphalt Products Co. v. Comm'r*, Nos. 84-1841, 84-1822 slip op. (6th Cir. July 17, 1986)). The conference agreement provides that the negligence penalty applies (once one element of negligence has been demonstrated) to the entire underpayment, not just to the portion attributable to negligence. The conference agreement is, with respect to this issue, a continuation of the rule of present law, which also provides that the negligence penalty applies to the entire underpayment, not just to the por-

> tion attributable to negligence. The conferees note that this case both inaccurately states present law and is in any event of no effect under the conference agreement.

Thus, the Conference Report on the 1986 Act, which apparently was not considered by the court of appeals here, makes it absolutely plain that the court of appeals' decision is in error.[4]

3. The decision of the court of appeals is at odds with every other decision that has considered this aspect of Section 6653(a). In particular, it directly conflicts with the Second Circuit's decision in *Abrams* v. *United States*, 449 F.2d 662 (1971) (per curiam). The court there expressly rejected the taxpayer's contention that the 5% negligence penalty should be applied against only the portion of the underpayment specifically attributable to negligence, holding that the penalty's application to the entire underpayment was "mandated by the relevant statute" (449 F.2d at 663). The court explained (*id.* at 664 (emphasis in original)):

[4] The decision below was entered on July 19, 1986, and the government's petition for rehearing was filed on August 28, 1986. The petition for rehearing was denied on September 25, 1986, the same day that the House passed the Tax Reform Act, two days before the Senate passed it, and more than two weeks before the President signed it. Pursuant to Rule 28(j) of the Federal Rules of Appellate Procedure, the government mailed a copy of the relevant portions of the Conference Report to the court of appeals on September 22, 1986, but there is no indication that the court considered this additional evidence before denying the Commissioner's petition for rehearing three days later. Because the court of appeals would likely find Congress's comments on the decision below to be relevant, we suggest that it might be appropriate for the Court to vacate the decision below and remand for reconsideration in light of this intervening development.

> The plain meaning of the Code is that the five percent penalty must be assessed against the 1960 tax deficiency of $39,317.38 and not just against that part of it ($5,748.39) due to negligently unreported income. The statute provides (26 U.S.C. § 6653(a)) if *"any part"* of an underpayment is due to negligence, the five percent penalty is to be added to the underpayment. It is evident that it was intended that the five percent was to be assessed not just against that segment of the deficiency due to negligence but against the entire amount. The language is clear and leads to no other interpretation.

Accord, *e.g.*, *Bianchi* v. *Commissioner*, 66 T.C. 324, 325 (1976), aff'd, 553 F.2d 93 (2d Cir. 1977) (Table); see also *Robinson's Dairy, Inc.* v. *Commissioner*, 35 T.C. 601, 609 (1961), aff'd, 302 F.2d 42 (10th Cir. 1962); *Lester Lumber Co.* v. *Commissioner*, 14 T.C. 255, 262-263 (1950).[5]

[5] In an effort to justify its decision, the court of appeals below (App., *infra*, 14a) seized on the following language in the last paragraph of the Second Circuit's opinion in *Abrams* (449 F.2d at 664):

> Appellants argue that a literal application of the statute could lead to absurd results where a comparatively insignificant item of income is negligently omitted. That case is not before us on this appeal and we therefore express no opinion whatever as to its proper disposition if it should ever arise.

This passage obviously provides no support for the decision below; the *Abrams* court simply posited a hypothetical question not before it and expressly declined to suggest an answer. While we see no conceivable basis for avoiding the plain command of the statute in *any* circumstances, we note that, contrary to the statement of the court below (App., *infra*, 14a), the hypothetical put forth in *Abrams* is not presented in this case either. Here, respondent did not negligently

There are also numerous decisions in the Sixth Circuit and in other circuits holding that the 50% fraud penalty, imposed in parallel fashion by Section 6653 (b) and its statutory predecessors, is applicable to the entire amount of the underpayment, not just to the portion of the underpayment that is attributable to fraud. See, *e.g.*, *Levinson* v. *United States*, 496 F.2d 651, 653-656 (3d Cir.), cert. denied, 419 U.S. 1040 (1974); *Romm* v. *Commissioner*, 245 F.2d 730, 736 (4th Cir.), cert. denied, 355 U.S. 862 (1957); *Duffin* v. *Lucas*, 55 F.2d 786, 798 (6th Cir. 1932). The court of appeals below made no effort to reconcile this contrary authority. Thus, unless its decision is overturned, taxpayers in the Sixth Circuit will be subjected to substantially smaller negligence penalties than similarly situated taxpayers in other parts of the country, a species of unequal treatment that should not be permitted to stand.

4. The decision of the court below, unless reversed, will have a significant adverse effect on the administration of the tax laws. First, at least in the Sixth Circuit, it will substantially undermine the effectiveness of the negligence penalty. The penalty is not primarily designed as a method of directly increasing revenue. Rather, its principal function is deterrence—to induce taxpayers to comply with the revenue laws in the first instance. As the Second Circuit pointed out in *Abrams*, 449 F.2d at 664 (emphasis in original): "The five percent penalty for negligence and the fifty percent penalty for fraud are in fact *penalties* and their imposition on the entire tax deficiency for the year is not only clearly provided for

omit an insignificant item of income, but affirmatively took a deduction for non-business-related expenses to which it later conceded it was not entitled.

in the statute but serves to act as a deterrent." The possibility that a penalty will be imposed on the entire amount of a deficiency that will be determined at some future time is a substantial disincentive to negligent or intentional underreporting of tax. On the other hand, limiting the penalty to the amount attributable to the negligence, a much smaller sum that can be estimated by the taxpayer, would produce a far less powerful spur to voluntary taxpayer compliance. The taxpayer may well conclude that the possibility that his underpayment will not be discovered justifies the risk of exposure to such a limited penalty, and he may therefore choose to underreport his income and play the "audit lottery." In this case, for example, the negligence penalty, on the court of appeals' theory, would be about $25, approximately the average cost of a parking ticket. Thus, the decision below is likely to lead to reduced voluntary compliance with the tax laws, at least in the Sixth Circuit.[6]

[6] Such reduction in the negligence penalty's deterrent effect would be particularly troublesome in light of the degree to which the problem of noncompliance with the tax laws is increasing. As reflected in the *Annual Report of the Commissioner of Internal Revenue*, for the years 1978 through 1986 the total amount of negligence penalties asserted by the Commissioner has risen from $10,318,000 to $144,809,000. Congress has responded to the problem of taxpayer non-compliance by enacting several new penalty provisions (see, *e.g.*, I.R.C. §§ 6659, 6661), including, for taxable years after December 31, 1981, an additional time-sensitive penalty for underpayments attributable to negligence or fraud (I.R.C. §§ 6653 (a) (2) and (b) (2)). And, of course, Congress recently considered and rejected a proposal to limit the 5% negligence penalty to that portion of the underpayment specifically attributable to the negligence. See pages 6-8, *supra*.

Second, allowing the decision below to remain undisturbed will engender burdensome and unnecessary litigation. Many taxpayers against whom the negligence penalty is asserted are likely to try to bring themselves within the rule created by the court of appeals in this case. Under a proper construction of the statute, which computes the penalty on the entire amount of the underpayment, there is no point in a taxpayer's litigating over whether a particular portion of a deficiency is attributable to negligence. If a taxpayer is shown to have been negligent with respect to one item on his return, he has no reason not to concede his liability for the penalty even if he disagrees with the Commissioner's determination that he was negligent with respect to other items. The decision below, however, would create a strong incentive for contesting the Commissioner's determination of negligence on an item-by-item basis. The trial court would then be forced to take evidence and make specific findings with respect to each contested item, even though under the correct interpretation of Section 6653(a)(1) there should be no need to engage in such a tedious and laborious exercise. See, *e.g.*, *Lester Lumber Co.* v. *Commissioner*, 14 T.C. at 263.

The court of appeals' error, unless corrected, is likely to result in a considerable waste of administrative and judicial resources because of the frequency with which Section 6653(a) cases arise. Looking at the Tax Court alone, the negligence penalty is addressed in approximately 250 published decisions in a typical year. The IRS informs us, moreover, that as many as 10,000 of the petitions docketed annually in the Tax Court dispute the Commissioner's assertion of a negligence penalty. Many of these cases are ultimately settled and hence do not result in pub-

lished opinions. However, the Commissioner's ability to settle these cases would be significantly impaired by the decision below, which taxpayers will inevitably seek to use as a "bargaining chip" in the hope of avoiding a portion of the statutorily prescribed negligence penalty.

Finally, although the Tax Court will be free to adhere to its (correct) construction of Section 6653(a) in the generality of its decisions concerning the negligence penalty, the rule set forth in *Golsen* v. *Commissioner*, 54 T.C. 742, 757 (1970), aff'd, 445 F.2d 985 (10th Cir.), cert. denied, 404 U.S. 940 (1971), requires the Tax Court in a particular case to follow the law of the circuit to which the appeal will lie. Thus, in future cases appealable to the Sixth Circuit, the Tax Court will not be free to ignore the decision below when faced with taxpayer requests for extensive evidentiary proceedings concerning the item-by-item application of the negligence penalty. The Tax Court is already overwhelmed with a docket of some 50,000 pending cases and cannot easily shoulder the additional and unnecessary burden imposed by the Sixth Circuit's erroneous decision in this case.

CONCLUSION

The petition for a writ of certiorari should be granted. The Court may wish to consider summary reversal. Alternatively, the Court may deem it appropriate to vacate the court of appeals' decision and remand the case for reconsideration in light of the Tax Reform Act of 1986 and the accompanying Conference Report (see note 3, *supra*).

Respectfully submitted.

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APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

Nos. 84-1841/84-1882

ASPHALT PRODUCTS CO., INC.,
PETITIONER-APPELLANT, CROSS-APPELLEE

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT-APPELLEE, CROSS-APPELLANT

On Appeal from the United States Tax Court

Decided and Filed July 17, 1986

Before: LIVELY, Chief Judge; JONES and NELSON, Circuit Judges.

LIVELY, Chief Judge, delivered the opinion of the Court, in which JONES, Circuit Judge, joined. NELSON, Circuit Judge (pp. 14-22) delivered a separate opinion concurring in part and dissenting in part.

LIVELY, Chief Judge. This tax case presents issues related to the method of accounting employed by

a taxpayer and the application of the negligence penalty provided for in section 6653 of the Internal Revenue Code (the Code), 26 U.S.C. § 6653 (1982). Asphalt Products Co., Inc. (the taxpayer) appeals from a decision of the United States Tax Court upholding an income tax deficiency assessment by the Commissioner of Internal Revenue (the Commissioner) for 1974. The Tax Court also affirmed the addition of a five percent negligence penalty on the total deficiency. The Commissioner has filed a protective cross-appeal with respect to that portion of the decision of the Tax Court which credited the taxpayer with overpayments of its income taxes for 1975 and 1976. If this court should reverse the finding of a deficiency for 1974 based on the conclusion that the Commissioner erred in requiring the taxpayer to change its method of accounting, it would be necessary to recalculate the taxpayer's income tax liability for 1975 and 1976.

I.

A.

The taxpayer produces and sells emulsified asphalt, a road paving material. Its principal customers are county governments in its general area of Tennessee. The counties share in state gasoline taxes, and these taxes provide the revenues required for road construction and maintenance. The Arab oil embargo of 1973 created a double-barreled problem for the counties. The price of emulsified asphalt, whose principal ingredient is a residue from the refining of oil, rose rapidly, while the consumption of gasoline dropped sharply. Because of this combination of circumstances the taxpayer's accounts receivable increased from $72,000 on January 1, 1974 to $264,000 on the first day of 1975.

The oil embargo had an additional direct effect on the taxpayer's operations. Because emulsified asphalt cannot be used in cold weather, until 1973 the taxpayer never carried any inventory of asphalt or raw materials through the winter. Instead, it finished its run in December and closed its operation down completely for several weeks before the end of the year. As a result of the embargo, the suppliers of petroleum residue made allocations to their customers and required each to take its allocation every month or lose the right to receive raw materials in subsequent months. Aftr having only nominal ending inventories through 1973, the taxpayer had inventories on hand of $25,800 at the end of 1974 and $36,000 at the end of 1975. When more normal conditions returned, inventories at the end of 1976 fell to $1,583.

B.

From its inception the taxpayer employed the cash receipts and disbursements method of accounting. The Commissioner determined that the cash method did not accurately reflect the taxpayer's income, and assessed a deficiency for 1974 by recomputing the taxpayer's income using the accrual method of accounting. The Commissioner found that the use of inventories was necessary in order to reflect the taxpayer's income accurately, and applied the rule that a taxpayer must use the accrual method of accounting where inventories are a significant income-producing factor. The Commissioner also found that the fluctuations in accounts receivable made use of the cash method inappropriate because its use resulted in a "mismatching" of receipts from sales and cost of sales.

The taxpayer petitioned the Tax Court for redetermination of the deficiency. The Tax Court found that the Commissioner acted properly in requiring the taxpayer to change to an accrual method of accounting, and upheld the deficiency determinations.

C.

The taxpayer claimed a deduction of $1,103 on its 1974 return for the expenses of transporting personal property of two shareholders from California to Tennessee. The taxpayer took delivery of two new trucks in California and sent its drivers there to bring the trucks to Tennessee. The two principal shareholders of the taxpayer had purchased wastewater treatment plants in California to use in a Tennessee development. The truck drivers hauled the plants to Tennessee, using the new trucks they picked up in California, and the taxpayer deducted the salaries and reimbursed expenditures of the drivers as business expenses.

The taxpayer conceded in the Tax Court that the deduction for salaries and expenses of the drivers was not properly taken. The Commissioner assessed a 5% negligence penalty on the entire deficiency rather than assessing it only on the deficiency resulting from the improper deduction. The penalty exceeded $6,900, though the improperly claimed deduction was only $1,103. The Tax Court affirmed this addition to tax for 1974.

II.

A.

With respect to methods of accounting, § 446 of the Code, in applicable part, provides:

§ 446. General rule for methods of accounting

(a) General Rule.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) Exceptions.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

(c) Permissible methods.—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) the cash receipts and disbursements method;

(2) an accural method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

26 U.S.C. § 446 (1982). Treasury Regulations follow the statute and permit a taxpayer to compute taxable income under either the cash or accural method and require that taxable income be computed on the basis of the same method of accounting regularly used in keeping the taxpayer's books. 26 C.F.R. § 1.446-1(a). Reflecting the provisions of Code section 446(b), an exception to this general rule appears in 26 C.F.R. § 1.446-1(b)(1):

(b) *Exceptions.* (1) If the taxpayer does not regularly employ a method of accounting which

> clearly reflects his income, the computation of taxable income shall be made in a manner which, in the opinion of the Commissioner, does clearly reflect income.

In addition there is a special rule related to inventories in 26 C.F.R. § 1.446-1(c)(2)(i):

> (2) *Special Rules.* (i) In any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized under subdivision (ii) of this subparagraph.

A related regulation describes the conditions under which the use of inventories is necessary:

> In order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor.

26 C.F.R. § 1.471-1.

B.

From the foregoing code provisions and regulations the Commissioner argues that the use of inventories is necessary in order to reflect the taxpayer's taxable income correctly since the production and sale of merchandise is an income-producing factor. The use of inventories being necessary, the accrual method of accounting must be used. Thus, the Commissioner asserts, he did not abuse his discretion in requiring the taxpayer to adopt the accrual method. In the alternative, the Commissioner contends that the presence of a significant amount of accounts receivable in 1974 and subsequent years resulted in a

substantial distortion when the cash method of accounting was used. The failure to match sales with the true costs of goods sold produced a return that did not accurately reflect income. Based on the grant of discretion in § 446 of the Code, the Commissioner maintains that he acted properly in requiring the taxpayer to adopt the method of accounting that would "clearly reflect" its income.

The taxpayer contends that the Commissioner abused his discretion. Since the taxpayer had fairly and consistently reported its income for many years on a cash basis and the increase in inventories and accounts receivable resulted from forces over which it had no control, the taxpayer argues that the Commissioner acted arbitrarily. Inventories became "necessary" only by reason of a temporary and "aberrational" condition, not because the ordinary operations of its business required them. Recognizing the fact that the Commissioner has broad discretion to require a change of accounting methods, the taxpayer argues the authority to do so is limited to cases where "the method used does not clearly reflect income," 26 U.S.C. § 446(b), and this is not such a case. The taxpayer relies on the second "special rule" contained in 26 C.F.R. § 1.446-1(c)(2)(ii):

> No method of accounting will be regarded as clearly reflecting income unless all items of gross profit and deductions are treated with consistency from year to year.

The taxpayer's argument turns the negative statement of the regulation into a positive rule that *if* all items of gross profit and deductions are treated with consistency from year to year, the method of accounting *must* be regarded as clearly reflecting income.

III.

The Commissioner acts for the Secretary of the Treasury and § 446 of the Code clearly gives the Secretary very broad discretion to require a particular method of accounting. The only limitation on the exercise of this discretion appears to be that the method in use does not clearly reflect income and that a different method is required to do so. However, this preliminary determination is also left to the Commissioner. The Supreme Court has construed § 446 [formerly § 41 of the 1939 Code] as follows:

> The Commissioner has broad powers in determining whether accounting methods used by a taxpayer clearly reflect income, *Lucas v. American Code Co.*, 280 U.S. 445, 449; *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, 189-190, and under § 41 of the Internal Revenue Code of 1939, 26 U.S.C. (1952 ed.) § 41, the Commissioner, believing that the accounting method employed by a taxpayer "does not clearly reflect the income," may require that "computation shall be made in accordance with such method as in [his] opinion . . . does clearly reflect the income."

Commissioner of Internal Revenue v. Hansen, 360 U.S. 446, 467 (1959). Thus, § 446 gives the Commissioner discretion with respect to two determinations. The Commissioner first determines whether the accounting method chosen by a taxpayer clearly reflects income. If the Commissioner concludes that the taxpayer's chosen method does not meet this standard, he has the further discretion to require that computations be made under the method which, in his opinion, does clearly reflect income. It would

be difficult to describe administrative discretion in broader terms.

It is the taxpayer's position that the requirement that a method of accounting clearly reflect income is not absolute, in that it does not require an exact matching of receipts from the sale of products with the costs of goods sold. If the requirement were absolute, it contends, the cash receipts and disbursements method of accounting would never be permitted because that method admittedly is inexact. Yet the Code and regulations do recognize and permit use of the cash method. The taxpayer urges us to follow cases which have held that the requirement is not absolute and that the Commissioner exceeds his authority when he insists that a taxpayer change from a method that has been fairly and consistently employed unless there has been some attempt to manipulate records or evade the payment of taxes. In *Osterloh v. Lucas*, 37 F.2d 277, 278-79 (9th Cir. 1930), the court stated:

> In our opinion, all that is meant [by the requirement that the method of accounting shall clearly reflect the income] is that the books shall be kept fairly and honestly; and when so kept they reflect the true income of the taxpayer within the meaning of the law. In other words, the books are controlling, unless there has been an attempt of some sort to evade the tax.

Osterloh has been cited by the Tax Court as stating a general principle, though we have found no case where it has been followed in circumstances like those of the present case.

The taxpayer also relies on two decisions from this court, both of which are distinguishable. In *Morris-*

Poston Coal Co. v. Commissioner of Internal Revenue, 42 F.2d 620 (6th Cir. 1930), the Commissioner based a deficiency assessment on his finding that a taxpayer had changed its method of accounting without prior approval. The court concluded that the facts did not support his finding and reversed an order of the Board of Tax Appeals upholding the deficiency assessment. The significant difference between the present case and *Morris-Poston* is that the Commissioner in *Morris-Poston* failed to make a determination that the accounting method employed by the taxpayer did not clearly reflect income. Rather the Commissioner sought to require the taxpayer to accrue rental income on the erroneous finding that the taxpayer had changed its accounting method without prior approval. As the court pointed out, ". . . the right of the commissioner to reject the taxpayer's theory of income in this kind of a case stands upon the Commissioner's preliminary finding that the method employed by the taxpayer did not clearly reflect the income." *Id.* at 621. The authority to require a taxpayer to change its accounting method is not available for enforcement of other Code provisions. It may be used only as provided in § 446, after a determination has been made that the method in use does not clearly reflect income.

Glenn v. Kentucky Color & Chemical Co., 186 F.2d 975 (6th Cir. 1951), may be distinguished on the same basis. The Court in *Kentucky Color* stated:

> The Commissioner does not here assert, and so far as this record shows has never asserted that the taxpayer's method of accounting and reporting its taxes did not clearly reflect its income. He asserts that the method used is the accrual method and that therefore the Commissioner was

> authorized to order the accrual of the items involved. But the Commissioner's authority to order a change in accounting methods when the taxpayer has regularly employed a consistent method depends upon his finding that the taxpayer's method does not clearly reflect the income.

Id. at 977 (citation omitted). The same fact distinguishes *Magnon Service Electric Corp. v. Commissioner of Internal Revenue*, 73 T.C. 980 (1980), a recent decision which cited *Osterloh*. In *Magnon* the Commissioner based a deficiency upon a finding that the taxpayer should have used the percentage of completion method rather than the cash receipts and disbursements method of accounting with respect to long-term construction contracts. The Commissioner made no express determination under § 446 that the cash method of accounting did not clearly reflect income.

In each of the cited cases other than *Osterloh* the courts have concluded that the Commissioner was seeking to exercise a statutory power without making a preliminary determination which the statute establishes as a prerequisite. These cases do not limit the Commissioner's discretion when § 446 is properly applied. Instead, they stand for the proposition that the Commissioner cannot resort to his § 446 authority to require a change in accounting method just because he disagrees with a taxpayer's choice of method. That is not the situation in the present case. Here the Commissioner concluded that the cash method did not clearly reflect the taxpayer's 1974 income because inventories were a necessary element of its income-producing activities and the presence of substantial accounts receivable at the end of the year meant that the cost of goods sold had been deducted while

the proceeds from the sales of these goods had not been included in income. This "mismatching" resulted in reporting that did not clearly reflect income.

When the Commissioner concludes that a taxpayer's method of accounting does not clearly reflect income, the taxpayer has a heavy burden to show that the Commissioner has abused his discretion. A taxpayer does not overcome that burden by merely showing that it has "fairly and consistently" reported its income in the past. As in the present case, a change in conditions might render the past method of accounting inaccurate. Though the temporary increase in inventory in the present case was not significant, the large increase in accounts receivable created a situation where only use of the accrual method of accounting would avoid a serious distortion. Under these circumstances, the Commissioner's finding that the cash method no longer clearly reflected the taxpayer's income was fully supported by the record and the requirement that the taxpayer adopt the accrual method for 1974 and subsequent years was not an abuse of discretion.

We agree with the court in *Caldwell v. Commissioner of Internal Revenue*, 202 F.2d 112, 114-15 (2d Cir. 1953), where it stated that the requirement that books reflect income "clearly" means "accurately," not just "fairly and honestly." Where the Commissioner has determined that the accounting method used by a taxpayer does not clearly reflect income, in order to prevail, the taxpayer must demonstrate substantial identity of results between his method and the method selected by the Commissioner." *Wilkinson-Beane, Inc. v. Commissioner of Internal Revenue*, 420 F.2d 352, 356 (1st Cir. 1970).

We realize that the result seems harsh in this case. If the temporary and rather insignificant increase in

inventories of raw materials had been the only basis for the Commissioners' determination, we would have been inclined to find an abuse of discretion. We do not construe the Code provisions and regulations relating to inventories in the absolute terms adopted by the Commissioner and the Tax Court. However, the taxpayer's method of accounting did not produce an accurate picture of its 1974 income. The income tax is structured on an annual basis. Using the cash method, the cost of materials sold in 1974 was deducted on the 1974 return, yet the proceeds from that portion of the same sales represented by the accounts receivable were not included in the taxpayer's gross receipts as reported on its return. Unlike the inventory item, the accounts receivable were not negligible before 1974 and did not shrink even to their former size at the end of the oil emergency. The taxpayer had accounts receivable of $238,000 at the end of 1976. These facts supported the Commissioner's determination that the cash receipts and disbursements method did not clearly reflect the taxpayer's income.

IV.

Section 6653(a) of the Code, in its entirety, provided:

> (a) Negligence or intentional disregard of rules and regulations with respect to income or gift taxes.—If any part of any under payment (as defined in subsection (c)(1)) of any tax imposed by subtitle A or by chapter 12 of subtitle B (relating to income taxes and gift taxes) is due to negligence or intentional disregard of rules and regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5 percent of the underpayment.

The Commissioner found that the taxpayer acted negligently in claiming a deduction for the cost of transporting the wastewater treatment plants to Tennessee. On the basis of this finding, the Commissioner added a 5% penalty to the entire deficiency assessment. Since the total deficiency assessment was more than $133,000, this resulted in a penalty of $6,943, though the deficiency attributable to the deduction was only the portion of the whole representing the tax on $1,103. The Tax Court upheld the Commissioner, concluding that the Code requires an addition of 5% to the entire underpayment.

There is case law to support the decision of the Tax Court. See *Vnuk v. Commissioner of Internal Revenue*, 621 F.2d 1318 (8th Cir. 1980); *Abrams v. United States*, 449 F.2d 662 (2d Cir. 1971). These cases bear no resemblance to the present case. In both there were egregious attempts to avoid the payment of taxes and one is left wondering how the taxpayers avoided the 50% fraud penalty imposed by § 6653(b) of the Code. In *Abrams* the taxpayer argued that literal application of § 6653(a) would lead to an absurd result where a 'comparatively insignificant item of income is negligently omitted." The court responded:

> That case is not before us on this appeal and we therefore express no opinion whatever as to its proper disposition if it should ever arise.

449 F.2d at 664.

"That case" is now before us. The bulk of the deficiency arose from the taxpayer's consistently following its accounting practices. In contesting the Commissioner's deficiency determinations it relied on

decisions of this court that arguably supported its position. The Commission did not claim a negligence penalty with respect to the actions of the taxpayer that resulted in all but a few hundred dollars of the $133,000 deficiency assessment. The taxpayer did not concede that it was negligent in claiming the disallowed deduction; it merely conceded that the deduction was erroneously claimed. We will not let the tail wag the dog. "Under all the circumstances of the instant case," *Frederick W. Finney*, T.C. Memo 1980-23, we conclude that the § 6653(a) penalty should be applied only to that portion of the deficiency attributable to the disallowed deduction.

The decision of the Tax Court is affirmed in part, reversed in part, and remanded for further proceedings consistent with this opinion. The cross-appeal is dismissed. No costs are allowed.

DAVID A. NELSON, Circuit Judge, concurring in part and dissenting in part. I concur wholeheartedly in Part IV of the court's opinion. Where the taxpayer is subject to a penalty only because of the negligent omission of a comparatively insignificant item of income, and the Commissioner also asserts that there is a large underpayment not claimed to be due to negligence, I agree with the court that it would be absurd to let the Commissioner calculate the negligence penalty by applying the statutory percentage to the sum of the negligent and non-negligent underpayments. The absurdity is compounded where, as here, it is a close question whether the non-negligent "underpayment" was an underpayment at all. The Tax Court clearly erred in failing to limit the measure of the negligence penalty to the underpayment that was negligent.

With respect to Part III of the court's opinion, I agree that the temporary and rather insignificant increase in the taxpayer's raw material inventories was probaly not sufficient, in itself, to justify a forced change in accounting methods. I concur in the court's conclusion on this point notwithstanding that the regulations, if they may be enforced in accordance with their terms, would apparently require the use of accrual accounting by anyone engaged in the kind of business in which this taxpayer was engaged.

The Commissioner's argument, as I understand it, boils down to this:

— 26 C.F.R. § 1.471-1 says that "inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor;"

— 26 C.F.R. § 1.446-1(c)(2)(i) says that "[i]n any case in which it is necessary to use an inventory the accrual method of accounting must be used . . . ."

— The production, purchase, or sale of merchandise is unquestionably an income-producing factor in the case at bar, so this taxpayer is automatically required to use the accrual method of accounting.

The Commissioner's logic seems unassailable on its face, but if we look beyond the language of the regulations I think we shall see several problems with the Commissioner's conclusion.

In the first place, the result produced here by a strict application of the regulations is hard to reconcile with the statute. 26 U.S.C. § 446(a) provides, subject to only two exceptions, that taxable income "shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." The law thus "plainly recognizes" that, as this court has repeatedly declared, "the selection of the system or method of keeping his books is primarily for the taxpayer." *Morris-Poston Coal Co. v. Commissioner of Internal Revenue*, 42 F.2d 620, 621 (6th Cir. 1930); *Glenn v. Kentucky Color & Chemical Co.*, 186 F.2d 975, 977 (6th Cir. 1951). The Secretary of the Treasury, and the Commissioner as his designee, have discretion to require the use of a particular method of accounting only where "no method of accounting has been reguuarly used by the taxpayer (a situation that does not obtain here) or where "the method used [by the taxpayer] does not clearly reflect income." 26 U.S.C. § 446(b). Except where one of those two conditions

has been shown to exist, the taxpayer enjoys an express statutory right to elect to "compute taxable income under . . . the cash receipts and disbursements method." 26 U.S.C. § 446(c).

Given the statutory right, I do not see how the regulations can be permitted automatically to require this taxpayer to use an accrual method of accounting unless we are prepared to accept the proposition that the Commissioner, by regulation, has made a valid determination that the cash method of accounting "does not clearly reflect income" in *any* case in which the production, purchase, or sale of merchandise is an income-producing factor. Such a determination would seem overbroad, particularly when we recall it is beyond dispute that the cash method of accounting *did* clearly reflect the income of this very taxpayer prior to 1973.

In the second place, although the Tax Court may in this instance have accepted the Commissioner's argument that as a matter of regulatory law the cash method can never clearly reflect any merchant's income, the Tax Court has frequently refused to construe the regulations in such absolute terms. As the Court of Appeals for the First Circuit pointed out in ***Wilkinson-Beane, Inc. v. Commisisoner of Internal Revenue***, 420 F.2d 352 (1st Cir. 1970) (a case the holding of which would require affirmance of the Tax Court's decision here for other reasons):

> "The Tax Court, in a variety of contexts, has recognized that the presence of inventories does not necessarily mean that the cash basis does not clearly reflect income. *See, e.g.*, Ezo Products, Co., 37 T.C. 385, 393 (1961); Estate of Howard T. Roe, 36 T.C. 939, 952 (1961); Michael Drazen, [34 T.C. 1070] at 1079 [(1960)]; Stanford R. Brookshire, 31 T.C. 1157, 1166 (1959), *aff'd*, 273 F.2d 638 (4th Cir.), *cert. denied*, 363 U.S. 827, 80 S.Ct. 1597, 4 L.Ed.2d 1523 (1960); Theodore H. Beckman, 8 B.T.A. 830, 831 (1927); 2 J. Mertens, Law of Federal Income Taxation § 16.03, at 6 (Malone rev. ed. 1967); *contra* Harry Hartley, 23 T.C. 353, 358 (1954)." 420 F.2d at 355-56, n.9.

In the third place, the testimony of the only witness offered by the Commissioner in this case flatly contradicts the reading of the regulations for which the Commissioner now contends. Notwithstanding that this taxpayer has always been engaged in the production, purchase, or sale of merchandise, and notwithstanding that it has thus always been "necessary [for this taxpayer] to use an inventory," the witness testified that "so long as the accounts that affect the difference between the cash receipts and disbursements method and the accrual method do not change materially, *they could stay on* [*the cash*] *method*." (Emphasis supplied.)

Therefore, notwithstanding the seemingly unambiguous language of the regulations, I concur in the judgment that the regulations relating to inventories may not be construed in the absolute terms adopted by the Commissioner and the Tax Court.

This brings me to the question whether we must uphold the Commissioner's finding that the cash method did not clearly reflect this taxpayer's post-1973 income because of the presence of significant accounts receivable in 1974 and subsequent years. I would be inclined to answer this question differently than the court has done.

This taxpayer had accounts receivable on its books at the end of the 1974 tax year, to be sure, but that

was true of tax years before 1974 as well. Unless all its sales were made C.O.D., the business could always be expected to have accounts receivable at year end, with the result that its income in any given year, computed on a cash basis, could always be expected to differ from the income that would be reflected for that year under an accrual method of accounting. The differences ought to wash out over the life of the business, of course, and the mere existence of a difference, in a particular year, could not mean that either method failed clearly to reflect income. If Congress had intended otherwise it almost certainly would not have required taxable income to be computed under the accounting method regularly employed by the taxpayer, as opposed to requiring anyone engaged in the production, purchase or sale of merchandise to use an accrual accounting method. Neither would Congress have said, as it did say in 26 U.S.C. § 446(c), that a taxpayer "may" use "any" of a list of accounting methods headed, rather conspicuously, by the cash method. As the Tax Court has reminded us in this very case, the Commissioner "has no authority to force a taxpayer to change from a method which does clearly reflect income to another method which in his opinion more clearly reflects income;" and the statute, as this court declared in *Glenn v. Kentucky Color & Chemical Co.*, 186 F.2d 975, 977, *supra*, does not require of the taxpayer's accounting method "absolute precision."

It is true that because of the cash crunch experienced by the taxpayer's customers as a result of the Arab oil embargo, the taxpayer's accounts receivable—which, as the court acknowledges, were not negligible before 1974—had increased greatly by the end of 1974, and had not shrunk even to their former

size by the end of 1976. Under the taxpayer's cash accounting method, however, the decline in the taxpayer's income was less than it otherwise would have been because of a partially offsetting increase in the taxpayer's accounts payable. Just as the taxpayer's customers were taking longer to pay their bills, so the taxpayer was taking longer to pay its own bills—and under the cash method of accounting, the latter circumstance obviously worked to the advantage of the tax collector.

As the following chart shows, there was roughly a threefold increase in both the taxpayer's accounts receivable and its accounts payable between the beginning of 1974 and the end of 1976:

	1/1/74	12/31/76
Accounts Receivable	$72,304.59	$238,689.53
Accounts Payable	28,700.82	84,215.35

At the end of 1976, the gap between the taxpayer's accounts receivable and its accounts payable had increased by only $110,870.41; yet the accounting change imposed by the Commissioner caused a $258,075.63 jump in the taxpayer's 1974 income. The change in accounting methods thus boosted the taxpayer's income for that one year by more than 230% of the increase in the taxpayer's accounts receivable, net of accounts payable, over the entire three year period.

This result, as the court suggests, seems harsh. It seems especially so when we recall that the reason the taxpayer is being required to pay substantially *more* in taxes for 1974 is that it received substantially *less* in actual cash revenues that year. Recog-

nizing, as we must, that the way in which this taxpayer was applying its regular accounting method was unquestionably correct (a circumstance that sharply distinguishes this case from *Commissioner of Internal Revenue v. Hansen*, 360 U.S. 446 (1959), where accrual basis taxpayers were using accrual accounting in a way which was highly questionable under the statute and which "might well [have afforded] opportunities to accrual basis taxpayers to allocate income to years deemed most advantageous" (360 U.S. at 467)), it is hard to avoid the conclusion that the curbstone equities favor the taxpayer here.

This taxpayer is also aided, I believe, by the holding of this court in *Morris-Poston Coal Co. v. Commissioner of Internal Revenue*, 42 F.2d 620 (6th Cir. 1930), a case which is closely analogous to this case on its facts. There, as here, the taxpayer was on a cash accounting basis. At the end of the year 1921 the taxpayer had on its books a $108,000 receivable that would have been included in 1921 income had it been paid when due; because of a business depression, however, there was some delay in payment and the taxpayer did not actually receive the money until 1922. The Commissioner insisted that the account owed the taxpayer at the end of 1921 should have been accrued as 1921 income, just as he insisted that the money owed the taxpayer in this case at the end of 1974 should have been accrued as 1974 income. This court pointed out, in *Morris-Poston*, that the Commissioner's right to compel the taxpayer to account for the $108,000 as 1921 income, even though the money was not actually received in that year, "stands upon the Commissioner's preliminary finding that the method employed by the taxpayer did not clearly reflect the income." The Commissioner did not

deny that the taxpayer's 1921 tax return clearly reflected its 1921 income, said the court, "*unless for the fact that it contemplated assigning to the year 1922 this [$108,000] income, which was in fact received in that year.*" 42 F.2d at 621. (Emphasis supplied.) "The only question," the court concluded, "is whether the [return] truly reflected the taxpayer's income for 1921; and we think it did." 42 F.2d at 623.

The Commissioner did argue, unsuccessfully, that the taxpayer in *Morris-Poston* had changed its method of accounting without prior approval, but that fact does not distinguish *Morris-Poston* from this case if it was also the Commissioner's position, as it seems to have been, that the taxpayer' accounting method did not clearly reflect the taxpayer's income for 1921.

This court did not, in *Morris-Poston*, explicitly follow the decision handed down earlier this year in *Osterloh v. Lucas*, 37 F.2d 277 (9th Cir. 1930). In *Glenn v. Kentucky Color & Chemical Co.*, 186 F.2d 975, *supra*, however, (a per curiam opinion by Chief Judge Hicks and Circuit Judges Simons and Allen), the court did cite *Osterloh* in support of the proposition that "[t]he statute requires *only* that the taxpayer's books shall be kept fairly and honestly, without any attempt to evade the tax." 186 F.2d at 977. (Emphasis supplied.) There may be much to be said for the position, advanced in *Caldwell v. Commissioner of Internal Revenue*, 202 F.2d 112 (2d Cir. 1953), and *Wilkinson-Beane, Inc. v. Commissioner of Internal Revenue*, 420 F.2d 352, *supra*, that the statute does not require "only" that the books be kept fairly and honestly, but also requires, as the *Wilkinson-Beane* court put it, that the taxpayer's accounting method reflect his income "with as much ac-

curacy as standard methods of accounting permit." 420 F.2d at 356. That position is contrary to the one taken by this court in *Glenn*, however, as *Wilkinson-Beane* noted (see 420 F.2d at 356, n.12), and I am not sure we ought to follow *Wilkinson-Beane* without explicitly overruling our decisions in *Glenn* and *Morris-Poston*.

Osterloh, the Ninth Circuit decision applied by this court in *Glenn*, was a case in which the Commissioner required the taxpayer to continue to adhere to the cash method of accounting where the use of that method happened to work to the Commissioner's advantage. The reasons given by the court in upholding the Commissioner are instructive:

> "The method of accounting regularly employed by the petitioner [the cash receipts and disbursements method] is a recognized one within the meaning of the act, and should be accepted as controlling unless such method does not clearly reflect the income.
>
> * * * *
>
> If [the requirement that the method of accounting clearly reflect income] is absolute, it is safe to say that the books kept on the basis of cash received and disbursed will rarely, if ever, reflect the true income, because nearly always at the end of a tax year accounts due the taxpayer will remain uncollected and some of his own obligations will remain unpaid. But *we do not think that any such literal construction was contemplated.* In our opinion, all that is meant is that the books shall be kept fairly and honestly; and when so kept they reflect the true income of the taxpayer within the meaning of the law. In other words, the books are controlling, unless there has been an attempt of some sort to evade the tax. *This construction may work to the advantage of the taxpayer or the government at times, but if followed out consistently and honestly year after year the result in the end will approximate equality as nearly as we can hope for in the administration of a revenue law.*" 37 F.2d at 278-79. (Emphasis supplied.)

Citing *Wilkinson-Beane, Inc. v. Commissioner*, ¶ 69,079 P-H Memo T.C. (1969), *aff'd.* 420 F.2d 352 (1st Cir. 1970), the opinion of the Tax Court in the instant case says that "[t]he test in *Osterloh v. Lucas* has been narrowed by code changes and by new regulations and does not apply where the production, purchase, or sale of merchandise is an income-producing factor and where it has been determined that income is not clearly reflected in petitioner's method." I do not think this will wash in a circuit in which *Morris-Poston* and *Glenn* still constitute binding precedent. As to the "code changes" of which the Tax Court speaks, I know of none that is relevant. As to the regulations on the taxation of businesses in which the production, purchase or sale of merchandise is an income-producing factor, we have seen that these regulations are not controlling here. And as to the Commissioner's determination that "income is not clearly reflected in petitioner's method," the validity of that determination is precisely what we are to decide—and the logic of *Osterloh v. Lucas*, like the logic of *Morris-Poston* and *Glenn*, says that this determination must not be permitted to stand.

Accordingly, and with respect, I dissent from the court's decision to uphold the Commissioner's deter-

mination. I would reverse the decision of the Tax Court insofar as it denies the taxpayer the right to calculate its 1974 income under the method of accounting regularly used in prior years, and I would hold for the Commissioner on his protective cross-appeal from the Tax Court's decision that the taxpayer overpaid its 1975 and 1976 income taxes.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 84-1841/1882

ASPHALT PRODUCTS COMPANY, INC.,
PETITIONER-APPELLANT, CROSS-APPELLEE

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT-APPELLEE, CROSS-APPELLANT

[Filed July 17, 1986]

Before: LIVELY, Chief Judge; and JONES and NELSON, Circuit Judges.

JUDGMENT

ON APPEAL from a decision of the Tax Court of the United States.

THIS CAUSE came on to be heard on the transcript of record from the said Tax Court and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjusted by this court that the deci-

sion of the said Tax Court in this cause be and the same is hereby affirmed in part, reversed in part, and the case is remanded for further proceedings consistent with this opinion. The cross appeal is dismissed.

No costs taxed.

ENTERED BY ORDER
OF THE COURT

JOHN P. HEHMAN
Clerk

/s/ John P. Hehman
Clerk

Issued as Mandate: October 7, 1986

COSTS: NONE

Filing fee	$
Printing	$
Total	$

A True Copy.

Attest:

/s/ Tom Bennignus
Deputy Clerk

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 84-1882/1841

ASPHALT PRODUCTS, CO., INC., PETITIONER
J. CLARK AKERS, III, ET AL.,
PETITIONERS-APPELLANTS, CROSS-APPELLEES

v.

COMMISSIONER OF INTERNAL REVENUE,
REPONDENT-APPELLEE, CROSS-APPELLANT

[Filed Sept. 25, 1986]

BEFORE: LIVELY, Chief Judge, JONES and NELSON, Circuit Judges

ORDER

The Court having received a petition for rehearing en banc, and the petition having been circulated not only to the original panel members but also to all other active judges of this Court, and no judge of this Court having requested a vote on the suggestion for rehearing en banc, the petition for rehearing has been referred to the original hearing panel.

The panel has further reviewed the petition for rehearing and concludes that the issues raised in the petition were fully considered upon the original submission and decision of the case. Accordingly, the petition is denied.

ENTERED BY ORDER
OF THE COURT

/s/ John P. Hehman
JOHN P. HEHMAN
Clerk

APPENDIX D

T. C. Memo. 1984-208

UNITED STATES TAX COURT

J. CLARK AKERS, III and ELEANOR M. AKERS, ET AL.,[1]
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Dockets Nos. 6717-77, 5873-80,
6729-77, 5874-80,
6734-78, 5875-80,
6758-78, 5876-80.
6759-78,

Filed April 24, 1984.

Held: 1. Fair market value of wastewater treatment plants was $75,000 when donated to Vanderbilt

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[1] Cases of the following petitioners are consolidated herewith: William B. Akers and Jo Ann Akers, docket Nos. 6729-77, 6759-78, 5876-80; Estate of James C. Akers, Estelle L. Akers, Executrix and Estelle L. Akers, docket No. 5874-80; and Asphalt Products Company, Inc., docket Nos. 6758-78 and 5873-80.

University; 2. Respondent did not abuse discretion in requiring Asphalt Products Co., Inc. to change from the cash to the accrual method of accounting; 3. Medical insurance and reimbursement payments made by Asphalt Products Co., Inc. were made pursuant to a plan qualifying under sec. 105, I.R.C. 1954; 4. Payments made for the benefit of James C. Akers, Jr. and Estelle L. Akers are not constructive dividends to J. Clark Akers, III and William B. Akers; 5. Asphalt Products Co., Inc. may deduct such payments as ordinary and necessary business expenses under sec. 162, I.R.C. 1954; 6. James C. Akers, Jr. and Estelle L. Akers realized taxable income from the bargain rental and purchase of a residence from Asphalt Products Co., Inc.; 7. J. Clark Akers, III and William B. Akers did not receive constructive dividends from Asphalt Products Co., Inc.; and 8. For the taxable year 1974, Asphalt Products Co., Inc. is liable for the negligence addition determined under sec. 6653(a), I.R.C. 1954 attributable to its deduction of expenses incurred in transporting waste-water treatment plants.

Mark H. Westlake and *Ervin M. Entrekin*, for the petitioners.

John L. Hopkins and *Robert B. Nadler*, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

IRWIN, *Judge*: In these consolidated cases, respondent determined deficiencies in petitioners' Federal income taxes and additions to tax as follows:

Docket Nos.	Petitioners	Year	Income Tax Deficiency	Addition to Tax Sec. 6653(a)[2]
6717-77	J. Clark Akers, III and Eleanor M. Akers	1967	$ 874.24	
		1968	3,453.27	
		1969	6,174.33	
		1970	5,597.34	
6729-77	William B. Akers and Jo Ann Akers	1967	772.53	
		1968	3,125.46	
		1969	5,632.80	
		1970	5,131.60	
6734-78	J. Clark Akers, III and Eleanor M. Akers	1974	15,704.93	
		1975	47,603.88	
6758-78	Asphalt Products Company, Inc.	1974	154,332.16	$7,716.61
		1975	7,151.98	357.60
6759-78	William B. Akers and Jo Ann Akers	1974	14,927.70	
		1975	53,713.62	
5873-80	Asphalt Products Company, Inc.	1976	17,031.14	
5874-80	Estate of James C. Akers, Estelle L. Akers Executrix and Estelle L. Akers	1976	12,929.62	
5875-80	J. Clark Akers, III and Eleanor M. Akers	1976	56,089.00	
5876-80	William B. Akers and Jo Ann Akers	1976	56,186.00	

After concessions by petitioners and respondent,[3] the issues remaining for our decision are:

[2] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue and all references to Rules are to the Tax Court Rules of Practice and Procedure.

[3] J. Clark Akers, III concedes the adjustment to income for the taxable years 1967 through 1970 set forth as adjustment (a) in the statutory notice dated March 31, 1977 in the amounts of $269.74, $4,483.17, $6,340.03, and $5,420.02 for the years 1967 through 1970, respectively. For the taxable years 1974 and 1975, with respect to the statutory notice dated March 23, 1978, he concedes: (1) the adjustment set forth

(1) whether respondent correctly determined the fair market value of two wastewater treatment plants and related equipment donated to Vanderbilt University

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as adjustment (c) in the amounts of $1,345 for 1974 and $1,329 for 1975; (2) the adjustment set forth as adjustment (d) in part, in the amounts of $495.75 for 1974 and $1,960 for 1975; and (3) the adjustment marked as adjustment (e) for 1974 in the amount of $3,429.28. For the taxable year 1976, with respect to the statutory notice dated January 25, 1980, J. Clark Akers, III concedes adjustment (d) in the amount of $298 and adjustment (e) in the amount of $732.

William B. Akers concedes the adjustment to income set forth as adjustment (a) in the statutory notice dated March 31, 1977 in the amounts of $269.74, $4,481.64, $6,315.03, and $5,385.02 for the years 1967 through 1970, respectively. For the taxable years 1974 and 1975, with respect to the statutory notice dated March 23, 1978, he concedes: (1) a portion of adjustment (c) for 1975 in the amount of $1,960; (2) adjustment (d) in the amounts of $515 for 1974 and $900 for 1975, and (3) adjustment (e) in the amount of $2,176.50 for 1974. For the taxable year 1976, with respect to the statutory notice dated February 7, 1980, he concedes adjustment (e) in the amount of $1,740 and adjustment (f) in the amount of $732.

For the taxable year 1974, with respect to the notice of deficiency dated March 23, 1978, Asphalt Products Company, Inc. concedes adjustment (f) in the amount of $1,103.04. With respect to the statutory notice for 1976 dated January 25, 1980, Asphalt Products Company, Inc., concedes adjustment (f) in the amount of $298.50 and adjustment (g) in the amount of $213.49. With respect to these statutory notices, respondent and Asphalt Products Company, Inc. have agreed to compromise the adjustment marked as adjustment (b) with respect to travel and entertainment expenses for the years 1974 through 1976 as follows: 1974, $7,065.38; 1975, $6,293.27; 1976, $5,096.58.

For the taxable years 1974 through 1976, with respect to the statutory notices dated March 23, 1978, January 25, 1980, and February 7, 1980 for both J. Clark Akers, III and William

in 1975 by J. Clark Akers, III and William B. Akers; (2) whether Asphalt Products Company, Inc. properly reported income using the cash basis method, or whether it must use the accrual method of accounting; (3) whether medical insurance and reimbursement payments by Asphalt Products Company, Inc. to or for the benefit of James C. Akers, Jr., J. Clark Akers, III, and William B. Akers, were made pursuant to a plan qualifying under section 105; (4) whether the portion of these payments made for the benefit of James C. Akers, Jr. and Estelle L. Akers should be treated as constructive dividends to shareholders J. Clark Akers, III and William B. Akers; (5) whether Asphalt Products Company, Inc. may deduct such payments as ordinary and necessary business expenses under section 162; (6) whether James C. Akers, Jr. and Estelle L. Akers realized taxable income due to the below fair market rental or bargain purchase of a residence from Asphalt Products Company Inc.; (7) whether J. Clark Akers, III and William B. Akers received constructive dividends from Asphalt Products Company, Inc. by virtue of such bargain rental and sale; and (8) whether Asphalt Products Company, Inc. is liable for section 6653(a) negligence additions for 1974 and 1975.

B. Akers, respondent concedes the portion of the adjustments relating to dividend income for salary paid the petitioners' father in the following amounts in each statutory notice: $5,760 for 1974; $5,400 for 1975; and $10,800 for 1976. With respect to the statutory notices dated March 23, 1978 (adjustment (c)) and January 25, 1980 (adjustments (d) and (e)), respondent concedes that the salary paid to James C. Akers, Jr. during 1974, 1975, and 1976 is deductible by Asphalt Products Company, Inc. in the following amounts: $11,520 for 1974; $10,800 for 1975; and $10,800 for 1976.

FINDINGS OF FACT—GENERAL

Some of the facts have been stipulated. The written and oral stipulations, together with the attached exhibits, are incorporated herein by this reference.

Petitioners J. Clark Akers, III (hereinafter sometimes referred to as Clark) and Eleanor M. Akers are husband and wife who, at the time of filing their petitions with this Court, were residents of Nashville, Tennessee. They filed joint Federal income tax returns for the calendar years 1967 through 1970 with the Southeast Service Center, Chamblee, Georgia, and for the calendar years 1974 through 1976 with the Memphis Service Center, Memphis, Tennessee.

Petitioners William B. Akers (hereinafter sometimes referred to as William) and Jo Ann Akers are husband and wife who, at the time they filed their petitions with this Court, were residents of Nashville, Tennessee. They filed joint Federal income tax returns for the calendar years 1967 through 1970 and an amended return for 1970 with the Southeast Service Center, Chamblee, Georgia. They filed joint Federal income tax returns for the calendar years 1974 through 1976 and an amended return for 1976 with the Memphis Service Center, Memphis, Tennessee.

Petitioner Asphalt Products Company, Inc. (hereinafter referred to as Asphalt Products) is a corporation with a principal place of business in Nashville, Tennessee at the time its petitions were filed. Its corporate Federal income tax returns for the calendar years 1974 through 1976 and an amended return for 1976 were filed with the Memphis Service Center, Memphis, Tennessee.

Estelle L. Akers (hereinafter referred to as Estelle) resided in Nashville, Tennessee at the time the petition was filed in docket No. 5874-80. For the calendar year 1976, Estelle L. Akers and the Estate of James C. Akers, Jr. filed a joint return and an amended return with the Memphis Service Center, Memphis, Tennessee. James C. Akers, Jr. (hereinafter referred to as James) died during 1976. Estelle died on January 3, 1982. Estelle and James were husband and wife, and are the parents of Clark and William.

Eleanor M. Akers and Jo Ann Akers are parties to these proceedings solely by virtue of having signed joint Federal income tax returns with J. Clark Akers, III and William B. Akers.

For organizational purposes, we have found facts separately for some issues in these consolidated cases. However, as certain facts are relevant to more than one issue, they may be used as a basis for resolution of more than one issue.

FINDINGS OF FACT—SPECIFIC

I. *Fair Market Value of Wastewater Treatment Plants*

In the early 1970's, Environmental Quality Engineering, Inc. (hereinafter referred to as EQE), a California corporation, built two portable wastewater treatment plants (plants). These plants were mounted on trailers. Some of the funds for the plants were borrowed from Pathfinder Resources, Inc. (Pathfinder), a subsidiary of Aladdin Industries of Nashville, Tennessee.[4] Between October 1972 and August 1973, EQE paid third parties approximately $165,000 for fabricating and furnishing the two

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[4] The amount borrowed from Pathfinder is not evident from the record in this case.

plants, and for related materials. Of the $165,000, approximately $54,000 was for refurbishing the equipment in July and August of 1973. These amounts do not include the initial cost of the trailers themselves, or the engineering, design, and overhead costs of EQE.

One of the wastewater treatment plants was designed specifically to demonstrate a process patented by the University of California under license to EQE. The other plant incorporates equipment which permits several chemical-physical wastewater treatment procedures to be performed independently. This capability allows the user to experiment with various forms of wastewater treatment at a particular site in order to confirm such laboratory experiments as, for example, the type and size of permanent water treatment plant necessary to treat suitably the effluents at a particular site.

When EQE failed financially, Pathfinder, as a secured creditor, offered the two plants for sale pursuant to sealed bids. Pathfinder reserved the rights to accept or reject the bids received. In May 1974, bids were sought by a letter stating that Pathfinder was disposing of "an advanced waste treatment process and two fully-equipped pilot plant trailers," that "[i]n excess of $300,000 was spent to equip the trailers," and that the patent process rights were available either in conjunction with or separately from the trailers. Subsequently, another letter was sent stating that a large number of spare parts valued at approximately $10,000, including "several electric motors, electric pumps, switch boxes, valves, and assorted pipe fittings * * *," were to be included with the two plants. The bid-solicitation letter was sent to eighteen individuals at companies active in the pollu-

tion control business, many of them manufacturers of pollution control equipment.

Only two bids were submitted to Pathfinder. One bid in the amount of $15,010 was submitted by Richard Clark, the former president and owner of EQE, who had designed and supervised the building of the two plants. The other bid in the amount of $17,500 cash was submitted by William B. Akers and J. Clark Akers, III. The Akers' bid was accepted.

On April 9, 1974, an inventory of the plants was performed in conjunction with the sale. In pertinent part, this inventory stated:

> The general overall condition of the equipment appeared to be in good condition. Since the equipment is stored out of doors, fairly near the bay, it is subject to a harsh environment and will need maintenance in the not to [sic] distant future if it is to retain its value.
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> * * * * *
>
> *Description of A.B.C. Equipment*
>
> The equipment * * * essentially consisted of two semi trailers (8′ wide x 40′ long with 8 tires —dual axle with dual wheels) on which were mounted a variety of tanks, pumps, etc., and various other paraphernalia located adjacent to the trailers on the ground.
>
> The trailers and other equipment are stored outdoors (in Caral Co. parking lot). In general, the equipment appeared to be in good condition. There was no opportunity to turn on any of the motors since the power lines were not connected. In addition to inventoried items, there were a large number of P.V.C. ball valves, fittings, and

pipe (2" ϕ). Power cables are housed in conduits beneath the trailer bed (which is of checker plate construction). Power outlets are located at various locations on the trailer bed. All of the motor drivers appeared to be 3 phase 230/460 volts type.

Chemical and Biological Sedimentation tanks are equipped with constant speed collector mechanisms. Rubber squeegees move the sludge to the tank draw-off point where variable speed Moyno pumps move the sludge to the next treatment unit.

The Recarbonation Device (burner) was partially disassembled and it was not possible to ascertain the method of its operation or the manufacturers [sic] name. It apparently runs on propane.

William and Clark took title to the two plants and the spare parts upon payment of the purchase price, and received a bill of sale dated July 17, 1974. The two plants and related equipment were transported to Nashville, Tennessee and arrived there in late July or early August.

The plants were inspected upon their arrival in Nashville by Professor Jack Roth of Vanderbilt University. Professor Roth determined that the plants were not in operating condition. He worked out an agreement with the Metropolitan Government of Nashville and Davidson County (hereinafter Metro), to restore, refurbish, and modify the plants. Metro would then have the right to use the plants in order to verify certain design parameters of a major expansion of its own wastewater treatment facilities.

During the fall of 1974 and winter of 1975, Metro had under study and design by its consultants, Con-

soer, Townsend & Associates, a major expansion of its Nashville wastewater treatment plant. During this period, Metro painted, repaired, and made the two pilot wastewater treatment plants operational for their use. The two plants were then used by Metro to study a proposed wastewater nitrification plan.[5]

Vanderbilt University also conducted experiments using one of the plants during 1975 and 1976.[6] These experiments were conducted as a part of an Environmental Protection Agency (EPA)-funded biological treatment study. This study attempted to develop a monitor[7] that would predict the behavior of "upsets" to waste treatment plants. The plant and related equipment were necessary to test the monitor on a "reasonable scale" apparatus.

William and Clark conveyed title to the plants to Vanderbilt University on December 31, 1975. The document accompanying the transfer was entitled "Bill of Sale," and provided that William and Clark conveyed to Vanderbilt University their "right, title

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[5] Specifically, the plants were used to determine the feasibility of wastewater nitrification in a single stage activated sludge system to obtain effluent NH_3-N concentrations of less than 5 mg/1. The results of the pilot plant studies vertified certain design parameters such as organic loading rates, solid productions, and oxygen requirements.

[6] At the time, Vanderbilt University had an extensive environmental engineering program. The Center for Environmental Quality Management was an organization within Vanderbilt that encompassed a number of departments. The EPA grant was obtained through this Center.

[7] In full, the "monitor" was called a "Biological Simulation Monitor for a Joint Municipal/Industrial Treatment System."

and interest" in the two plants "[f]or the purpose of making a charitable contribution to Vanderbilt University School of Engineering and with the understanding that [the plants were] needed to further enable the School of Engineering to carry out its educational purpose * * *."

At approximately the date of the transfer, two appraisals were requested and obtained by Vanderbilt University. The first, from Jerry Shell of Environmental Engineers, provided a cost estimate of the two plants based on Shell's judgment of the condition of the plants and their replacement cost. The appraisal was based on his observation of the plants on October 16, 1975. The plants were found to be in good operating condition. A detailed cost breakdown of the value of the separate parts of the plant totaled $105,-635. To this amount, $79,226, or 75 percent of the total cost of the separate plant parts was added for the cost of "engineering, erection and contingencies." The appraisal indicated that the percentage was based on the high degree of complexity of the equipment and its controls. Thus, the estimated value of the two plants totaled $184,861.

The second appraisal, dated December 29, 1975, was from William F. Brandes of Smith, Seckman, Reid, Inc., Consulting Engineers. This appraisal estimated the value of the plants and the related spare parts using two different methods. After considering both methods, Brandes determined that the plants had a fair market value of $210,000. The first method used the following approach. The actual fabrication and erection costs of the two plants were estimated. To this figure, 100 percent was added for concept, design, and engineering. Accordingly to

Brandes, this percentage was used because the plants were "unique items, highly original and employing advanced technology. * * * A great deal of professional time and experimentation was necessarily involved in devising these plants." To these direct and indirect costs, Brandes added the value of the spare parts estimated at between $4 and $6 per pound. Thus the total estimated value was:

Trailer #1	$38,290
Trailer #2	43,965
Development and Engineering	82,255
Parts and Accessories	46,000
Total	$210,510

The second method of estimating value was based on a projected reasonable rental fee, including repair and maintenance. This method determined that a reasonable rental fee for the two plants was $15,000 per month. Repair, refitting, and maintenance was assumed to cost 25 percent of rental. Additionally, a 50 percent "utilization factor" and a nine percent interest rate were added over a life of 48 months. Under this method, the present worth of the equipment was calculated to be approximately $225,000.

In December 1980, at the request of petitioners, an appraisal of the plants was made by Dr. John H. Koon, Director of Waste Management for Associated Water and Air Resources Engineers, Inc. In his appraisal report of May 1, 1981, Koon broke down his estimate of value as follows:

Item	Present Cost Trailer 1	Trailer 2	April 1974 Cost Trailer 1	Trailer 2
Tanks	$ 20,765	$ 20,700	$10,380	$10,350
Equipment	12,390	18,180	6,030	9,600
Installation and Assembly	18,580	27,270	9,050	11,000
Piping	10,230	9,100	7,000	7,000
Wiring and Electrical Control	12,300	13,700	6,830	7,600
Grating, Ladder and Platform, structural	3,000	1,500	1,500	750
Engineering, Planning Construction Supervision	22,720	22,720	12,600	12,600
8 x 40 ft Trailer	15,000	15,000	9,000	9,000
	$114,985	$128,170	$62,390	$67,900
Total cost (Excluding two boxes of spare parts and equipment)	$243,155		$130,290	

Two boxes of instruments, spare motors, pumps, pipe hoses, pipe fittings, wiring, laboratory equipment and wet weather gear were not available for inspection by Dr. Koon.

Respondent had Stephen A. Wilgus, engineer, appraise the plants and estimate their worth in 1975. In carrying out his appraisal, Wilgus made an on-site inspection of the two plants on January 4, 1982. He also interviewed several persons: three from Metro; two from Vanderbilt; a sales representative of Envirex, a firm that manufactures, sells, and leases pilot plants; and one from Consoer, Townsend & Associates. After considering the cost, market, and income approaches to valuation, Wilgus concluded that the fair market value of the two plants on December 31, 1975 was $20,500. This conclusion was based on the assumptions that the plant title was marketable and free of liens, that his sources of data were reliable,

and on the incorrect assumption that all repairs made by Metro were made after December 31, 1975.

II. *Method of Accounting used by Asphalt Products*

Asphalt Products (petitioner) is a producer of emulsified asphalt.[8] Emulsified asphalt, a product used in paving roads, is manufactured from pure asphalt using a chemical treatment and physical process. Emulsified asphalt is preferable to pure asphalt in road paving because it can be spread at much lower temperatures, resulting in energy savings in preparation and application.

Originally, Asphalt Products bid on road paving jobs and when a bid was successful, it prepared the emulsion and subcontracted the paving job to the Globe Company, Inc. (Globe), a road contracting company incorporated in 1959. All stock of Globe was owned by the Globe Company Partnership (Globe Partnership), which after 1965, was owned by William and Clark. In 1971, Globe sold its principal operating assets and its name was changed to Akers, Inc. The Globe Partnership, however, was not dissolved. Subsequently in 1973, Akers, Inc. transferred its assets to Asphalt Products. After this time, Asphalt Products was in the contracting business.

Very little road contracting work is done by Asphalt Products in the colder months of December, January, and February. Asphalt Products generally closed its operations completely in mid-December, and all employees took vacations from mid-December until early January.

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[8] We include a description of the various branches of the business of Asphalt Products only insofar as is relevant to the issues under our consideration.

Emulsified asphalt solidifies when not kept warm and is ruined when it freezes. Consequently, Asphalt Products did not keep any finished product in its tanks during the two-week shutdown period. The company sold its finished product prior to the plant shutdown, leaving no yearend inventory of finished product. Furthermore, Asphalt Products generally did not have a significant stockpile of raw materials in mid-December, because sales of its products slowed during wintertime, increasing again around the beginning of March.

This general inventory-clearing procedure changed in 1973 due to the Arab embargo on oil sales to the United States. Asphalt emulsion raw materials are derived from oil refining-process residue. The oil-refining company suppliers of Asphalt Products indicated that it had to purchase its quota by a certain date to assure the availability of raw product in a subsequent year. Asphalt Products was, therefore, obliged to maintain some inventories of raw material at year-end.

Several Tennessee counties, customers of Asphalt Products, were also affected by the embargo. Previously, the price of the asphalt emulsion rose only 11 cents per gallon in 1951 to 14 cents in 1973. In 1974, the price rose to 28 cents and by 1982, the price was 75 cents per gallon. As the price rose, gasoline consumption declined. Because the counties received a portion of their funding for road work from a two-cent per gallon gasoline tax, they had difficulty meeting payments owed on work for which they had contracted in previous years. Thus, Asphalt Products' accounts receivables increased.

Asphalt Products always reported its Federal income tax liability on the cash basis method of accounting. Its books are maintained on a cash receipts and

disbursements basis. With regard to the asphalt portion of the business, work papers are prepared in the form of balance sheets and list accrual accounts for the company. These workpaper balance sheets were instituted so that the company management could keep track of cash flow during their busy months.

Figures available in the books, records, and workpapers of Asphalt Products showed the following accrual account balances for January 1, 1974 through December 31, 1976:

	1-1-74	12-31-74	12-31-75	12-31-76
Inventory	$16,453.76	$ 25,812.83	$ 36,374.86	$ 1,583.00
Accounts Receivable	71,482.09	264,269.42	256,078.17	237,991.75
Accounts Receivable-Inspection	822.50	425.81	523.30	697.78
Accounts Payable-Trade	27,892.83	9,567.36	63,227.53	82,626.55
Accounts Payable-Royalties	435.31	270.02	297.25	136.96
Accounts Payable-Sales Taxes	372.68	156.34	220.52	1,451.84

The difference between taxable income shown on returns filed by Asphalt Products for the years at issue, and taxable income as calculated by respondent under the accrual method, taking into account appropriate adjustments is compared in the following chart:

	1974	1975	1976
Taxable income on return	$117,803.55	$ 37,963.51	$ 38,780.20
Taxable income on statutory notice	439,497.44	59,383.32	80,339.13
Adjustment to taxable income based on change of accounting method	280,514.34	(51,283.31)	(73,173.85)
Taxable income taking into account 10-year spread forward	375,879.18	35,727.87	10,704.74

In 1974, Asphalt Products received about $120,000 as its portion of a judgment from a lawsuit concerning the collection of a contract amount dating back to 1967. Taxes were paid when the judgment was received, according to the cash method practice.

III. *Benefits to Officers and Employees of Asphalt Products*

James was born in 1891. He graduated from Vanderbilt University School of Engineering in 1912. He worked for a short time as an independent engineer and then served in the United States Army Corps of Engineers during World War I. In 1925, he became the first Director and Engineer of the Davidson (Tennessee) County Highway Department and served in that capacity until his retirement in 1955. During his time with the Davidson County Highway Department, James was instrumental in designing legislation for Tennessee that gave part of the state gas tax revenue to counties for highway departments.

Originally all Tennessee counties paved with hot asphalt. Pure asphalt was transported to Davidson County in railroad cars. The asphalt then was heated in the railroad cars for up to two days before it could be transferred to an applicator machine. The applicator machine also had to have a heat source sufficient to maintain the high temperatures required for spraying. At a temperature of approximately 300 degrees Fahrenheit (about 149 degrees Celsius), the asphalt became liquid and would be sprayed on the roadbed.

In the mid-1920's, early in James' career with the Davidson County Highway Department, James met John Kelly (Kelly), who owned an emulsified asphalt plant in Terre Haute, Indiana. When James learned that the use of emulsified rather than pure asphalt

would produce savings in energy, money, and labor, he entered into an agreement with Kelly to have a plant placed in Davidson County. Thus, Davidson County began using emulsified asphalt in the late 1920's, although most rural, mid-Tennessee counties continued to use pure asphalt through the 1940's.

In the late 1940's, Kelly set up a private emulsified asphalt company, the predecessor of Asphalt Products, in order to sell emulsified asphalt throughout mid-Tennessee. Kelly hired William Akers (William) to help with the company. At that time, William was with the United States Corps of Engineers, had served in the Navy in World War II, and received his graduate engineering degree from the Massachusetts Institute of Technology. In the early 1950's, Kelly gave Williams an option to purchase a half interest in Asphalt Products, but continued to operate the company himself.

Clark graduated from Vanderbilt University in 1949 and worked first for a general contracting company, and then a paving contracting company. In 1953, he went to work for Asphalt Products. By 1955, Asphalt Products had two Tennessee branches, one in Nashville and one in Knoxville.

In 1955, Kelly asked James to work for Asphalt Products as a salesperson. He was to try to persuade county road superintendents throughout Tennessee to switch to emulsified asphalt. At that time, James was particularly qualified for the job, in that he belonged to the "County Road Superintendents and County Road Engineers Association," a group of all Tennessee county road superintendents (the members of which he had come to know quite well), and because of his longstanding experience in emulsified asphalt. Consequently, James started work as a salesman for Asphalt Products. After he started this job, he was

elected Secretary of the Tennessee County Highway Association.

In 1962, another salesman, G. Webb Cowan (Cowan), was hired by Asphalt Products. Cowan then called on company customers until 1967, when he became seriously ill. After Cowan died, Asphalt Products hired James Love, who died unexpectedly in 1974.

Kelly formed Globe, Inc. in 1959 to provide paving services for Asphalt Products. In 1965, the shareholders divided the two branches of Asphalt Products. The physical assets and trade name were distributed to William and Clark, who eventually incorporated the assets under the name Asphalt Products. Since that time, all stock of Asphalt Products has been owned by the Globe Partnership. William and Clark each own a 50 percent interest in the Globe Partnership.[9]

A. *Medical Benefits*

On March 10, 1959, Globe adopted a plan entitled "Accident and Health Plan for Officers." The plan provided for the reimbursement or direct payment of medical expenses as defined in section 213, for officers, their spouses, and dependents. In addition, the plan included a "wage continuation plan" whereby an officer was entitled to at least a minimum wage of $100 per week while absent from work on account of sickness or personal injury.

On December 31, 1972, Asphalt Products adopted a plan entitled "Uniform Accident and Health Plan for Employees, Medical Expense Reimbursement and Disability Benefits Plan." This plan provided, in pertinent part:

[9] For more details, see the facts in section II, *supra*.

ITEM I

Purpose of the Plan

ASPHALT PRODUCTS COMPANY, INC. voluntarily establishes this plan in order to increase the social insurance protection available to its employees by providing them with medical expense reimbursement and benefits to replace wages lost by reason of absence from work because of occupational and non-occupational personal injuries and sickness. It is agreed and understood that *all qualified employees except officers employees shall be entitled to no benefits* until action of the Board of Directors establishing a benefit limit on a noncumulative basis for all qualified employees except officers; *and officer employees shall be subject to no limitation in benefits* until and unless the Board of Directors acts to adopt a limitation on the annual benefits payable pursuant to this plan. It is further agreed and understood that the corporation may in the discretion of its officers take out medical and/or hospitalization insurance in which event the premiums paid by the corporation shall be treated as payments under this section of the plan and shall be payable in addition to the limits hereinabove established, if any.

* * * * *

ITEM III

Benefits

1. *Reimbursement of Medical Expenses.*

If any * * * officer * * * presents a bill to said corporation for the payment of any "medical

expense" as that term is defined in Section 213 of the Internal Revenue Code of 1954 and the regulations and case law thereunder and said medical expense was incurred for the medical care of the particular employee, his or her spouse, or his or her dependents, as defined in Section 152 of the Internal Revenue Code of 1954, and such "medical expense" was incurred by said employee, his or her spouse, or his or her dependents at a time when said employee was employed by this corporation in a capacity so as to qualify said employee for benefits under this Plan, such "medical expense" shall be paid either directly by this corporation, or if for any reason the employee, his or her spouse, or his or her dependents, have previously paid such "medical expense" and can offer proof of such payment, this corporation shall reimburse to the employee an amount equal to the amount so paid in lieu of direct payment of said "medical expense."

* * * * *

It is agreed and understood that all qualified employees except officer employees shall be limited to $———— in benefits, such limitation is to be non-cumulative; and officer employees shall be limited to $———— in benefits for any one calendar year, such limitation to be non-cumulative. It is further agreed and understood that the corporation may in the discretion of its officers take out medical and/or hospitalization insurance in which event the premiums paid by the corporation shall be treated as payments under this Section of the Plan.

2. *Wage Continuation.*

(a) An employee who is absent from work because of personal injury or sickness shall be paid by the Company on a weekly basis, a benefit for each day of such absence for which benefits are payable under this Item and Item IV hereof which is equal to his compensation divided by the number of days in his normal workweek.

* * * * *

ITEM IX

Rights

The Company may in its sole and absolute discretion determine additional medical benefits on an employee by employee basis.

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ITEM X

Reimbursement to Employer

The Company may in its sole and absolute discretion demand reimbursement for all items paid to the employee under this Plan which were disallowed as an exclusion from income on his individual federal income tax return and disallowed as a deductible business expense by the Company on its federal income tax return. If the preceding sentence applies, then it is to be conclusively presumed that the employee is not qualified under this Plan and that the payment made to him is made as a loan to said employee and that said employee must repay the money to the corporation within thirty (30) days from the date that the said determination is made together

with interest from date that the employee receives the payment at the rate of four percent (4%) per annum or such increase in interest as may be designated by the Commissioner of Internal Revenue Service is in regard to installment sales contracts which interest is presently stated to be four percent (4%) per annum.

* * * * *

Asphalt Products held a group medical policy for all its full-time employees with the Life and Casualty Insurance Company of Tennessee. The issue date on the policy was November 1, 1973.[10] The policy provided employees with accidental death, dismemberment and loss of sight benefits, and provided employees and their dependents with major medical expense benefits.

Asphalt Products' salesman, Cowan, became unable to work in July 1967, due to serious illness. The company paid a total of $5,950 in sick pay until Cowan's death in March 1968. Asphalt Products also paid medical expenses totaling approximately $10,000 in Cowan's behalf. Life and Casualty Insurance Company of Tennessee reimbursed Asphalt Products for $2,771.92 of this amount. Cowan was never an officer, director, or shareholder of Asphalt Products.

Fred Elkins was a truck driver for Asphalt Products. He became disabled and received $8,000 in sick pay from May 1, 1978 through April 15, 1979. Rudy Shelton and Clarence Holton also were truck drivers for Asphalt Products. Between July 1967 and April 1968, Asphalt Products paid medical expenses in the amounts of $403.60 for Rudy Shelton and $500 for

[10] This date, although in conflict with the stipulated date, is the effective date appearing on the policy.

Clarence Holton. Within this time period, Asphalt Products paid $193.19 in medical expenses for Phyllis Burns, a company secretary. Rudy Shelton, Clarence Holton, and Phyllis Burns were not officers, directors, or shareholders of Asphalt Products at any time.

Between January 1965 and April 1979, Asphalt Products paid $178,002.38 for medical insurance, sick pay, and in direct payment of employee medical expenses. Of this amount, $49,097.24 ($4,500 sick pay; $44,597.24, medical benefits) was spent to benefit employees who were shareholders and officers; $26,759.89 ($13,950, sick pay; $12,809.89, medical benefits) was spent for employees who were neither shareholders nor officers; and $102,145.25 was spent for group medical insurance premiums. The only officers of Asphalt Products from 1972 to 1976 were William, Clark, and James.

For the taxable year 1976, respondent held William and Clark taxable on alleged constructive dividends by virtue of medical expense payments made by Asphalt Products to James or Estelle.

B. *Residence*

In May 1959, soon after Globe was formed, Globe purchased a residence at 248 Harding Place, Nashville, Tennessee (hereinafter sometimes referred to as the Harding Place residence). On or about the same day, an option agreement was given by Globe to James and Estelle. The agreement was signed by Clark as president of Globe and provided:

OPTION

FOR AND IN CONSIDERATION of the Agreement by J. CLARK AKERS, JR. and wife ESTELLE L. AKERS to permit THE GLOBE

COMPANY, INC. to acquire certain property fronting 120 feet on the northeasterly side of Harding Place from L. W. Cherry and wife Evelyn M. Cherry and other good and valuable considerations, the receipt of all of which is hereby acknowledged as having been paid by J. Clark Akers, Jr. and wife Estelle L. Akers.

The Globe Company, Inc., acting by and through its duly authorized president agrees to the following:

1. J. Clark Akers, Jr. [James] and wife Estelle L. Akers may take possession and occupy said property described in Exhibit "A" attached hereto and pay therefor the cash sum of One Hundred Dollars ($100.00) per month together with all routine maintenance.

2. So long as said property is occupied by the said J. Clark Akers, Jr. and wife Estelle L. Akers, they or the survivor of them shall have the right and option to acquire said property for the cash purchase price of Twenty-One Thousand Five Hundred Dollars ($21,500.00) plus One Thousand Dollars ($1,000.00).

3. If the Optionee elects to exercise the option to purchase the property, the closing shall take place during the month of December in the year in which notice of exercise is given by the Optionee to the Optionor. The Optionee shall be credited with an amount equal to one-half (½) of the rental payments previously made and the balance shall be payable in cash.

Ownership in the property was retained by Globe and its successor corporations, Akers, Inc. and Asphalt Products. On December 31, 1976, Estelle purchased

the property from Asphalt Products for $22,500. Near the time of purchase, an independent appraiser found the fair market value of the property was $43,000.

During his employment with Asphalt Products Company, Inc. from 1965 to 1976, James was paid the following cash compensation:

Year	Amount
1965	$ 5,900
1966	7,500
1967	11,400
1968	10,400
1969	8,400
1970	14,400
1971	9,600
1972	9,600
1973	9,600
1974	11,520
1975	10,800
1976	10,800*

* Includes death benefit payment to Estelle L. Akers of $3,600

Respondent held William and Clark taxable on amounts relating to the alleged bargain lease and bargain sale of the Harding Place residence and property between Asphalt Products and James and Estelle. With respect to the residence, respondent also charged the full amount as income to James and Estelle, although in all cases agrees that no more than 100 percent of any of these items may be allocated among the individual petitioners.

OPINION

I. *Issue 1-Fair Market Value of Wastewater Treatment Plants*

When a taxpayer makes a contribution to a properly qualified charitable organization of property other than money, he is allowed a deduction in the amount of the fair market value of the property at the time of the contribution, reduced as provided in section 170(e)(1). Section 1.170A-1(c)(1), Income Tax Regs. The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of relevant facts. Section 1.170A-1 (c)(2), Income Tax Regs.

Our task here is to determine the fair market value of the two wastewater treatment plants as of December 31, 1975, the time they were contributed by William and Clark to Vanderbilt University. Respondent claims the equipment was worth $17,500 when donated to Vanderbilt, the same amount that William and Clark bid and paid to purchase the plants in 1974. As reinforcement for his position, respondent contends that his valuation is within the bounds marked at one end by the only other bid at the time the plants were purchased, in the amount of $15,000, and at the other end by the determination of his expert, Stephen A. Wilgus (Wilgus) that the plants were worth $20,500 in December 1975.

Petitioners William and Clark, on the other hand, claim that the fair market value of the plants when donated was $201,000. Petitioners derived this value from a rough averaging of the values obtained by their experts. Petitioners also contend that respondent's reliance on bid price and on Wilgus' appraisal is erroneous.

We find the fair market value of petitioners' donation at the time of contribution to Vanderbilt was $75,000.

Respondent contends that the price bid for the plants is a good indicator of their value. Respondent maintains that although the original sale was well-advertised in the industry, only one bid was received besides that of the petitioners. Respondent argues that this supports a finding that no resale market exists and that no objective proof is available to show that the plans were worth more.

We do not consider the winning bid price to be the best indicator of the value of the plants in this case. We furthermore doubt that even this price could constitute the "objective" proof which respondent seeks. Although we recognize that the market for the plants would of necessity be limited, it is not so limited as to necessitate restricting evidence of the value of the plants to the 1974 bid price.

Petitioners, moreover, convincingly have shown that notice of the sale did not go out to those who would be most interested. Indeed, none of the parties notified of the sale was interested enough to bid on the plants. Petitioners' expert, Dr. Koon, testified at trial that the list of potential buyers to whom notices of the sale were sent principally consisted of equipment manufacturers, leaving out more likely potential buyers such as environmental engineering consulting firms and research institutions. Equipment manufacturers usually design and manufacture their own plants to their own specifications and normally would not be interested in acquiring used plants from competing companies. Additionally, the marked dif-

ference between the cost of building and equipping the plants and the bid price indicates that bid price may not be the best means of valuation in the present case.[11]

Respondent also contends that the bid price should be used as the fair market value because petitioners bought the plants without expectation of reselling them. Respondent maintains that William and Clark did not know anything about the equipment, were not in the resale business, did not investigate a potential resale market, and did not inspect the equipment prior to purchasing it. Respondent argues that the evidence shows that William and Clark intended at all times to donate the plants to Vanderbilt and, therefore, the petitioners are only entitled to a deduction in the amount paid for the plants.

The facts contained in the record do not warrant our finding that petitioners acted as an agent for Vanderbilt in the purchase of the plants, nor do they warrant a conclusion that petitioners were compelled to donate the plants to Vanderbilt. The documents of title indicate that the plants were owned by the petitioners at all times before the donation. The fact that Metro and Vanderbilt may have used or examined the equipment would not have prevented William and Clark from prohibiting further use of the equipment, or from otherwise exerting their dominion and control over the plants. Moreover, the re-

[11] In finding an examination of other methods of valuation warranted, we also find the present valuation clearly distinguishable from the circumstances surrounding the sales in *Hotel de France Co. v. Commissioner*, 1 B.T.A. 28 (1924) and *Stollwerck Chocolate Co. v. Commissioner*, 4 B.T.A. 467 (1926) which respondent cites as support for his "bid price" argument.

pairs to the plants undertaken by Metro prior to the donation can be construed as an indirect fee for Metro's use of the plants for its own studies.

Respondent's expert, Wilgus, determined that the value of the two plants on the date of transfer was $20,500. The calculations of value were based primarily on an income approach using rental rates and amount of use estimates to adjust the expected gross revenue projections.

There are various weaknesses in this method of valuation. Wilgus did not take in account in his calculations the expenditures made by Metro before the date of the gift that restored the plants to full function and use. Furthermore, as petitioner correctly argues, the income and market approaches to an estimate of fair market value are not entirely reliable in a case such as this where there is a limited market for equipment. Wilgus acknowledged at trial that he had little information on which to base an income or market approach. In fact, Wilgus testified that, to his knowledge, there was no one who rented this type of equipment for profit in the marketplace. Wilgus also testified at trial that he had not included various spare parts in his valuation estimates. Wilgus' appraisal of value was made in 1982, several years after the gift, and therefore, is based in part on his extrapolations from interviews with various parties involved rather than on direct examination of the equipment. Finally, Wilgus ignored the unique value of these plants as a research tool. This is surprising in view of the fact that the plants were originally constructed as research aids, and not as traditionally "fixed" wastewater treatment plants.

Petitioners' experts had considerable experience in the wastewater treatment field. All their calculations

of fair market value used the cost approach to valuation, although Brandes used a projected rental value approach as well as a cost approach. Despite the recognized expertise of petitioners' evaluators, we are not disposed to accept their various calculations without certain modifications. Expert testimony is not required to be accepted as gospel, and we may evaluate their testimony in light of the entire record. See *Dayton Power & Light Co. v. Public Utilities Commission*, 292 U.S. 290, 298-300 (1934); *Cupler v. Commissioner*, 64 T.C. 946, 956 (1975); *Keystone Wood Products Co. v. Commissioner*, 19 B.T.A. 1116, 1121 (1930), affd. 66 F.2d 258 (2d Cir. 1933).

The appraisals by Terry Shell and William F. Brandes were made near the time of the donation and show that the plants were in operating condition in 1975. The cost approach used, however, does not account for depreciation or wear and tear. Both the nature of the work required of the plants and the storage conditions dictate some adjustment for these factors. At issue in the present case is a determination of the fair market value of the plants at the time of the gift, and not the potential reproduction cost. The same failure to adjust for current equipment condition is also demonstrated in the estimate of value made by Dr. John H. Koon. Respondent questions the adjustments for inflation rate in the Koon estimate. We do not think that this adjustment as used by Dr. Koon, significantly affected the projected estimate of 1974 worth. Offsetting any error in that regard is the fact that Koon's estimate did not take into direct account the related spare parts and equipment donated with the machines.

Finally, we note that in addition to their general educational value, the plants were of value to Vanderbilt in obtaining a grant from the Environmental Protection Agency. Dr. John Roth, a professor of chemical and environmental engineering at Vanderbilt University testified he did not believe Vanderbilt would have received the grant without the plants or equivalent equipment. Testimony given by Dr. Koon also supports our conclusion that the equipment was of particular value. Dr. Koon testified that Vanderbilt was one of the top schools in the industrial wastewater treatment field at the time of the donation. As the plants were primarily suited for use as research tools, they were valuable additions to the Vanderbilt University environmental engineering department. The use to which donated property will be put is an element in determining value. *Cupler v. Commissioner*, 64 T.C. at 955; see *Guggenheim v. Rasquin*, 312 U.S. 254, 257 (1941).

After considering all the facts presented in the record in this case, we conclude that the fair market value of the plants at the time they were donated to Vanderbilt University was $75,000. Accordingly, we hold that the total amount of charitable contribution is $75,000.[12]

II. *Issue 2-Correct Method of Accounting*

Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. Permissible methods for computing taxable income include the cash receipts

[12] In arriving at this conclusion, we note as we often do in such cases that this Solomonlike pronouncement was made as we attempted to carve out the facets of a diamond with only a sledgehammer for a tool. See, e.g., *Messing v. Commissioner*, 48 T.C. 502, 512 (1967).

and disbursements and the accrual methods. Section 446(c). An exception, however, is provided under section 446(b) whereby, when the method used by a taxpayer does not clearly reflect income, the computation of taxable income shall be made under such method as in the opinion of the respondent does clearly reflect income. See section 1.446-1(b)(1), Income Tax Regs. Respondent has broad discretion in determining whether a taxpayer's method clearly reflects income. *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 532 (1979); *United States v. Catto*, 384 U.S. 102 (1966); *Commissioner v. Hansen*, 360 U.S. 446, 467 (1959). Moreover, the taxpayer has a heavy burden in overcoming respondent's determination. *Thor Power Tool Co. v. Commissioner, supra*; *Lucas v. Structural Steel Co.*, 281 U.S. 264, 271 (1930); *Brooks-Massey Dodge, Inc. v. Commissioner*, 60 T.C. 884, 889 (1973). The standard used is that respondent's determination must not be interfered with unless clearly unlawful or plainly arbitrary. *Thor Power Tool Co. v. Commissioner*, 439 U.S. at 532-533.

Inventory must be accounted for in a taxpayer's method of accounting. Section 1.446-1(a)(4)(i), Income Tax Regs. provides:

> (i) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, merchandise on hand (including finished goods, work in process, raw materials, and supplies) at the beginning and end of the year shall be taken into account in computing the taxable income of the year. * * *

Additionally, with respect to the provision in section 446(c) allowing the use of either cash or accrual

method, a special rule is included in the regulations whereby, when it is necessary to use an inventory, the accrual method of accounting must be used with regard to purchases and sales, unless otherwise authorized under section 1.446-1(c)(2)(ii), Income Tax Regs. Section &1.446-1(c)(2)(i), Income Tax Regs., provides:

> In any case in which it is necessary to use an inventory the accrual method of accounting *must* be used with regard to purchases and sales unless otherwise authorized under subdivision (ii) of this subparagraph. [Emphasis supplied.]

Section 1.446-1(c)(2)(ii), Income Tax Regs., provides in part:

> [T]he Commissioner *may* authorize a taxpayer to continue the use of a method of accounting consistently used by the taxpayer, even though not specifically authorized by the regulations in this part, if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. * * * [Emphasis supplied.]

Petitioner has accounted for its inventory within its method of accounting, the cash method, and contends that the cash basis method of accounting did clearly reflect its income during the years at issue. In maintaining this position, petitioner relies on the standard set forth in *Osterloh v. Lucas*, 37 F.2d 277 (9th Cir. 1930), and contends that it is entitled to use the cash method because it had consistently, fairly, and honestly kept its books using this method. Petitioner additionally argues that the cases on which respondent relies are contrary to the meaning and intent of section 446, and that inventory was not a

material item in reflecting the income of Asphalt Products, Inc.

Respondent, relying on his broad authority under section 446(b) to reject a method of accounting that does not clearly reflect income, argues that Asphalt Products must switch to the accrual method of accounting. Respondent maintains the accrual method is called for because inventory is a material income-uproducing factor in the business of petitioner Asphalt Products, and because business practices had changed so that as of 1974, the cash receipts and disbursements method of accounting did not clearly reflect petitioner's income.

We agree with respondent that petitioner must change its method of accounting.

Petitioner has used the cash method of accounting to report its income from the inception of its business. Petitioner argues that because respondent had no previous objections to the use of this method, it is entitled to continue its use.

Where respondent has accepted a method of accounting over a long period of years, this fact is given weight in determining whether respondent was justified in changing the method used by such taxpayer. *Ezo Products Co. v. Commissioner*, 37 T.C. 385, 391 (1961); *Geometric Stamping Co. v. Commissioner*, 26 T.C. 301 (1956). It does not, however, preclude a determination that another method must now be used. The authority to order a change in accounting method where a longstanding method is in use depends on the validity of respondent's finding that a taxpayer's method does not clearly reflect income. *Ezo Products Co. v. Commissioner, supra; Glenn v. Kentucky Color & Chemical Co.*, 186 F.2d 975, 977 (6th Cir. 1951). Respondent has broad powers in determining whether an accounting method

clearly reflects income, but has no authority to force a taxpayer to change from a method which does clearly reflect income to another method which in his opinion more clearly reflects income. *Bay State Gas Co. v. Commissioner*, 75 T.C. 410, 417 (1980), affd. 689 F.2d 1 (1st Cir. 1982); *Auburn Packing Co. v. Commissioner*, 60 T.C. 794, 800 (1973); *Garth v. Commissioner*, 56 T.C. 610, 623 (1971). Thus the success of petitioner's contention that it is entitled to use the cash method turns on whether the cash method clearly reflects petitioner's income.

For all years at issue, petitioner was in the business of manufacturing and selling asphalt and asphalt products and performed some paving work via its contracting business. Corporate books show balances reflecting inventories and accounts receivable. It is evident under the facts of this case that the production, purchase and sale of emulsified asphalt is an income-producing factor in petitioner's business and, therefore, that merchandise on hand, including oil byproducts and other raw materials, must be taken into account in computing the taxable income of petitioner. See sec. 1.446(c)(2)(i), Income Tax Regs.

During the years at issue, petitioner of necessity maintained inventories of the raw materials used in its asphalt emulsion business. Because it was necessary to maintain inventories, petitioner's income could not be clearly reflected by the use of the cash method. Inventory is a material income-producing factor in petitioner's business.[13] Furthermore, the

[13] The presence of temporary inventory "blips" and higher accounts receivable than in pre-1974 years indicates that the underlying nature of petitioner's business has changed from the earlier, less volatile and less inflationary years.

fluctuation in accounts receivable is substantial in relation to petitioner's income. See *Ezo Products Co. v. Commissioner*, 37 T.C. at 392. We think the evidence in the record is sufficient to show that respondent's determination that the cash receipts and disbursements method does not clearly reflect petitioner's income is not clearly arbitrary or unreasonable. Accordingly, we are compelled to find that respondent did not abuse his discretion in arriving at his conclusion. *Thor Power Tool Co. v. Commissioner*, 439 U.S. at 532-533. Furthermore, there was no showing of respondent's active acceptance of a past method of accounting in the present case and, therefore, the factual situation in *Magnon v. Commissioner*, 73 T.C. 980 (1980), is distinguishable. The "fair and honest" standard of *Osterloh v. Lucas*, *supra*, is similarly inapplicable in the present case. The test in *Osterloh v. Lucas* has been narrowed by code changes and by new regulations and does not apply where the production, purchase, or sale of merchandise is an income-producing factor and where it has been determined that income is not clearly reflected in petitioner's method.[14] We hold, therefore, that petitioner must change its method of accounting to an accrual method.

III. *Issues 3, 4, and 5—Medical Plan*

Section 105(a) provides that amounts received by employees under accident and health plans, to the extent attributable to employer contributions, generally are includable in gross income.[15] Section 105

[14] See *Wilkinson-Beane, Inc. v. Commissioner*, T.C. Memo. 1969-79, affd. 420 F.2d 352 (1st Cir. 1970).

[15] Section 105(a) provides:

Amounts Attributable to Employer Contributions.—Except as otherwise provided in this section, amounts received by an employee through accident or health insurance for personal injuries or sickness shall be included in gross income to the extent such amounts (1) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (2) are paid by the employer.

(b) carves out an exception to this general rule for amounts "paid, directly or indirectly, to the taxpayer to reimburse the taxpayer for expenses incurred by him for the medical care * * * of the taxpayer, his spouse, and his dependents * * *." Section 105(e) specifically provides that "amounts received under an accident or health plan for employees * * * shall be treated as amounts received through accident or health insurance."[16]

[16] The following guidelines for defining an accident and health plan are presented in sec. 1.105-5(a), Income Tax Regs.:

* * * In general, an accident or health plan is an arrangement for the payment of amounts to employees in the event of personal injuries or sickness. A plan may cover one or more employees, and there may be different plans for different employees or classes of employees. An accident or health plan may be either insured or noninsured, and it is not necessary that the plan be in writing or that the employee's rights to benefits under the plan be enforceable. However, if the employee's rights are not enforceable, an amount will be deemed to be received under a plan only if, on the date the employee became sick or injured, the employee was covered by a plan (or a program, policy, or custom having the effect of a plan) providing for the payment of amounts to the employee in the event of personal injuries or sickness, and notice or knowledge of such plan was reasonably available to the employee. It is immaterial who makes payment of the benefits provided by the plan. For example, payment may be made by the employer, a welfare fund, a State sickness or disability benefits fund, an association of employers or employees, or by an insurance company.

When payments are properly excludable from an employee's income because they are made under a "plan for employees," they are deductible by the employer as ordinary and necessary business expenses under section 162(a). See sec. 1.162-10(a), Income Tax Regs. Furthermore, even when medical payments are not excludable from an employee's income under section 105, they may still be deductible by the employer under section 162(a)(1) as reasonable compensation expenses. See *American Foundry v. Commissioner* 59 T.C. 231, 243-245 (1972), affd. in part and revd. in part, 536 F.2d 289 (9th Cir. 1976).

Petitioners Asphalt Products, Clark, and William contend that all medical benefits and insurance payments were made under a qualified unwritten plan for all employees and a qualified written plan for officer-employees, and maintain that no payments were made to shareholders other than in their capacities as key employees of Asphalt. Alternatively, petitioners contend that if the payments for James were taxable, they were taxable as reasonable compensation income to James, and not as constructive dividends to Clark or William.

Respondent contends that the various medical payments made by Asphalt were not made pursuant to a qualified plan because no unwritten plan existed covering all employees and the written plan by itself was discriminatory. Furthermore, respondent maintains that the amounts distributed to the officer-shareholders did not constitute reasonable compensation. Consequently, respondent denies Asphalt Products any deductions and imposes on Clark and William added income either in the form of constructive dividends or as increased compensation.

We agree with the petitioners and characterize the medical payments made by Asphalt Products as qualified payments under section 105, not includable in the income of the recipients, and deductible by the employer under section 162.

It is clear that a plan as defined in section 1.105-5 (a), Income Tax Regs., existed when James, Clark, and William received medical benefits from Asphalt Products. In addition to the group medical insurance policy, there was an unwritten plan covering all employees. From the testimony and evidence in the record, it is clear that the existence of this plan was known to all employees. The medical expenses of company employees, although usually covered in full by the group policy, were covered by Asphalt Products when in excess of the $5,000 maximum group limit. The former payroll and bookkeeping secretary of Asphalt Products testified that Asphalt Products had paid all medical expenses in the one case during her tenure where expenses exceeded the group limit. She also testified that Asphalt Products had never refused to pay any employee medical expense. Clark also testified that it was the policy of Asphalt Products to pick up any difference between actual expenses and the amount paid by insurance.

A written plan also existed covering the corporate officers. Payments under this plan were not made on an arbitrary or ad hoc basis. Compare *Larkin v. Commissioner*, 48 T.C. 629 (1967), affd. 394 F.2d 494 (1st Cir. 1968), and *Lang v. Commissioner*, 41 T.C. 352 (1963), with *Giberson v. Commissioner*, T.C. Memo. 1982-338, and *Bogene, Inc. v. Commissioner*, T.C. Memo. 1968-147. At the time the plan was adopted, the corporate officers were James, Clark, and William. The question of whether the plan was

"for employees" depends upon whether the plan is "truthfully described by the labels which the parties have attached to them." See *Graybar Electric Co. v. Commissioner*, 29 T.C. 818, 832 (1958), affd. per curiam 267 F.2d 403 (2d Cir. 1959).[17] The plan in question provided benefits to James, Clark, and William, and their dependents, as employees of Asphalt Products. Plans limited to corporate officers who are also shareholders are not per se disqualified under section 105(b). See *Larkin v. Commissioner*, 48 T.C. at 635 n.5.[18]

As petitioners correctly argue, the plans offered by Asphalt Products were very similar to those in *Bogene, Inc. v. Commissioner, supra*, where medical benefits were provided to principal officer-employees of a corporation in addition to benefits provided under another plan which benefited all employees. The Asphalt Products plan did fix limits of the benefits in that all expenses would be reimbursed. Although Clark and William each held 50 percent of the Asphalt Products stock through the Globe Partnership, there was no relationship between their shareholder status and the amount of benefits to be paid. Clark, William, and James each played a key role in Asphalt Products by virtue of their training, experience, and

[17] See *Bogene, Inc. v. Commissioner*, T.C. Memo. 1968-147.

[18] The legislative history of section 105 has been sufficiently discussed in our previous opinions. See, e.g., *Bogene, Inc. v. Commissioner, supra*. It suffices for the purposes of this opinion for us to note that officer-employees may be covered to the exclusion of other employees in a qualified plan. See also *American Foundry v. Commissioner*, 59 T.C. 231, 242 (1972); *Epstein v. Commissioner*, T.C. Memo. 1972-53; *Smith v. Commissioner*, T.C. Memo. 1970-243; *Snyder v. Commissioner*, T.C. Memo. 1983-692.

management capabilities. It is clear that the genesis of the plan was the employee relationship rather than shareholder status and thus a rational basis other than ownership of the business existed to justify discrimination among different classes of employees. See *Levine v. Commissioner*, 50 T.C. 422, 427 (1968); sec. 1.105-5(a), Income Tax Regs.[19] We cannot accept respondent's characterization of the medical reimbursements to petitioners as distributions of corporate dividends. On the basis of the record before us, we conclude that medical payments to or for the benefit of petitioners James, Clark, and William were made under a plan for employees and not for shareholders. Accordingly, during the years at issue, the amounts received by the petitioners under the plan are excludable under section 105(b).

We conclude that the expenditures made by Asphalt Products under its "plan for employees" were ordinary and necessary. Consequently, petitioner Asphalt Products is entitled to a deduction for medical payments as ordinary and necessary business expenses under section 162(a).

IV. *Issues 6 and 7—Bargain Rental and Sale of Residence*

A shareholder or employee realizes an economic benefit taxable as income by the use of corporate assets for less than adequate payment in money or money's worth. Section 61; *Commissioner v. Smith*,

[19] See *Wigutow v. Commissioner*, T.C. Memo. 1983-620. We draw no conclusion as to whether the plan would satisfy the nondiscrimination requirement of section 105(h) in effect for claims filed and paid after December 31, 1979.

324 U.S. 177, 181 (1945); *International Artists, Ltd. v. Commissioner,* 55 T.C. 94, 105 (1970); *Dean v. Commissioner,* 9 T.C. 256 (1947); *Frueauff v. Commissioner,* 30 B.T.A. 449 (1934). See also *Commissioner v. Glenshaw Glass Co.,* 348 U.S. 426 (1955); *Greenspun v. Commissioner,* 72 T.C. 931, 947 (1979), affd. 670 F.2d 123 (9th Cir. 1982).

Section 301 provides that a distribution made by a corporation to a shareholder with respect to its stock shall be included in gross income to the extent it is a dividend (as defined in section 316). Section 316 defines a dividend as a distribution of property made by a corporation to its shareholders out of its earnings and profits. Property is defined in section 317 to include "money, securities, and any other property." Section 1.301-1(j), Income Tax Regs. provides, in part, that:

> If property is transferred by a corporation to a shareholder which is not a corporation for an amount less than its fair market value in a sale or exchange, such shareholder shall be treated as having received a distribution to which section 301 applies. In such case, the amount of the distribution shall be the difference between the amount paid for the property and its fair market value. * * *

Thus, although income generally is not realized by the purchaser when property is sold for less than its fair market value, a bargain sale by a corporation to a shareholder results in a dividend to the shareholder to the extent that the fair market value of property received exceeds the consideration paid. *Commissioner v. Gordon,* 391 U.S. 83, 89-90 (1968); *Honigman v. Commissioner,* 55 T.C. 1067, 1077

(1971), affd. on this issue 466 F.2d 69, 74 (6th Cir. 1972); *Lacy v. Commissioner,* 39 T.C. 1100 (1963), affd. 341 F.2d 54 (10th Cir. 1965); *Dellinger v. Commissioner,* 32 T.C. 1178, 1182 (1959). Whether the transfer or sale of property to the shareholder constitutes a dividend is determined by the circumstances and actual effect of a transaction, and not by the intent of the parties. *Palmer v. Commissioner,* 302 U.S. 63 (1937); *Dellinger v. Commissioner, supra.*[20]

The dispute with regard to the Harding Place residence may be summarized as follows: (1) whether the rental to James and Estelle at below fair market value resulted in (a) income to them in the amount determined by respondent, or (b) income to William and Clark by virtue of their relationship to James and Estelle; (2) whether the subsequent sale of the residence by Asphalt Products to Estelle was (a) performed pursuant to a bona fide option and if so, (b) whether the option contract was capable of valuation at the time made, or (c) alternatively, if no option of economic substance existed, whether the bargain sale resulted in income taxable to Estelle, or (d) in constructive dividends taxable to William and Clark.

Petitioners argue that Globe granted James and Estelle a binding option for consideration at a price reflecting the fair market value of the property at the time the option contract was formed. After casting the transaction in this light, petitioners contend that under *Palmer v. Commissioner, supra,* an employee or shareholder is not taxable on the grant or exercise of an option when fair consideration is given

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[20] See *Nelson v. Commissioner,* T.C. Memo. 1982-361, on appeal (10th Cir., Feb. 2, 1983).

in exchange for the option, even when the value of the property has increased by the time the option is exercised. Alternatively, petitioners assert that the difference between fair rental and sale value and the actual prics paid, if taxable, constituted additional compensation to James for his services to Globe, and did not represent dividend income to Clark and William.

Respondent determined the fair rental value of the Harding Place property was $375 per month in 1976 and its fair market value in 1976 was $43,000. Respondent argues that William and Clark realized constructive dividends during 1974, 1975, and 1976 in the amount of the difference between fair rental value and the amounts paid and that William and Clark also received a constructive dividend when the property was sold to Estelle in the amount of the difference between fair market value and the amount paid. Respondent contends that William and Clark were using their corporation to pay their personal expenses of caring for their parents and must realize constructive dividends represented by the amount of the bargain. Respondent asserts that there was no economic substance to the 1959 option agreement, no indication that the parties intended the option to constitute compensation for James' services, and no business purpose to the transaction. Respondent alternatively maintains that if an option existed, it had no ascertainable value when granted and therefore is taxable when exercised under the "open transaction" doctrine of *Burnet v. Logan*, 283 U.S. 404 (1931). Respondent finally argues that if we find the transactions do not give rise to constructive dividends to William and Clark, they give rise to income to James and Estelle under section 61.

We agree with petitioners and respondent to the extent they argue that the Harding Place residence transactions are taxable to James and Estelle as compensation under section 61.

As respondent correctly argues, the "option" given by Globe to James and Estelle was not an effective option contract. It was not signed by James and Estelle, and there is no evidence that the requirement of "fair consideration" was met, other than the recitation that such was given in the document. Although petitioners argue that the lease payments and agreement to maintain the property were valuable consideration, they offered no evidence to show that the payments of $100 per month were above a fair rental value in 1959, and thus, that a portion of such payments constituted fair consideration. In any event, the petitioners' contentions are not sufficient to overcome the presumption of invalidity of such contracts attendant in transactions between persons in fiduciary or confidential relationships.[21] Cf. *Palmer v. Commissioner, supra*; *Dellinger v. Commissioner*, 32 T.C. at 1182.

Respondent argues that the living expenses of James and Estelle were personal expenses of William and Clark, and that William and Clark as the officers and shareholders of Globe were using the corporate form to derive economic benefit while avoiding taxable dividends. Petitioners argue that James was a valuable employee of Globe and the rental of the

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[21] Cf. *Gordon v. Thornton*, 584 S.W.2d 655 (Tenn. App. 1979). Because we find that no option existed, we need not reach the issue of whether the transaction was taxable at the time the "option" paper was signed or when the Harding Place property was sold to Estelle. See *Baumer v. United States*, 580 F.2d 863 (5th Cir. 1978).

Harding Place residence was a benefit to him as an employee and not given as a result of the family relationship between James and the officer-shareholders, William and Clark. After considering the record in the present case, we find that William and Clark did not receive constructive dividends in the Harding Place residence transactions. See *Palmer v. Commissioner, supra; Dellinger v. Commissioner, supra; L. Schepp Co. v. Commissioner*, 25 B.T.A. 419, 429 (1932). The record shows that James was a uniquely valuable officer-employee of Globe, and later, of Asphalt Products. Several witnesses who were business associates of Asphalt Products, including county highway supervisors and a road commissioner, testified that James was one of the most respected authorities in the road paving and highway construction business. William testified that James was known as "the father of the highway departments" of Tennessee. James' association with Asphalt Products boosted company business considerably. We think it is clear that James was made an officer of the Globe company for reasons other than family considerations, and we think it is also plain that the rental of the house and bargain sale were a reasonable form of compensation for James' services.[22]

The economic benefit received by James and Estelle from the rental and sale of the Harding Place residence is taxable as compensation under section 61. Petitioners have not shown that the fair rental value of the house for the years at issue was other than that determined by the respondent and we find that the difference between $375 per month and the $100

[22] We recognize that Estelle made the actual purchase; however, on the record before us, we conclude that the price was set as a result of James' services to the corporation.

per month paid by James and Estelle is taxable to James as compensation under section 61.[23] Rule 142 (a); *Frueauff v. Commissioner, supra.* We also find that the 1976 fair market value of the Harding Place residence was $43,000. The difference between this amount and the amount paid by Estelle is taxable as compensation income for James' services to the corporation.[24] *Greenspun v. Commissioner, supra.*

V. *Issue 8—Section 6653(a) Negligence Additions*

In his notice of deficiency, respondent determined additions to tax under section 6653(a) against petitioner Asphalt Products for the taxable years 1974 and 1975. On reply brief, respondent conceded that petitioner was not liable for the additions to tax for 1975 in the amount of $357.60.

Section 6653(a) provides for an addition to tax if "any part of any underpayment * * * of any [income] tax * * * is due to negligence or intentional disregard of rules or regulations." Petitioners bear the burden of proving that the additions to tax do not apply. *Luman v. Commissioner*, 79 T.C. 846, 860-861 (1982); *Bixby v. Commissioner*, 58 T.C. 757, 791 (1972); Rule 142(a).

[23] Section 61, which defines gross income as "all income from whatever source derived," unless otherwise specifically exempted is broadly interpreted and encompasses in taxable income any economic or financial benefit conferred on an employee as compensation, whatever the form or mode by which it is effected. *Commissioner v. Smith*, 324 U.S. 177, 181 (1945); *Greenspun v. Commissioner*, 72 T.C. at 946-947; see also *Helvering v. Bruun*, 309 U.S. 461 (1940); *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1958); H. Rept. 1337, 83d Cong., 2d Sess. A18 (1954); S.Rept. 1622, 83d Cong., 2d Sess. 168 (1954).

[24] The parties did not raise the applicability of section 83 to the Harding Place residence transactions.

Respondent alleges that petitioner was negligent by accounting for its income on the cash method and because it deducted $1,103.04 in expenditures in connection with transporting two wastewater treatment plants from California to Nashville, Tennessee.[25] Petitioner denies negligence with respect to its method of accounting and asserts that its deductions with respect to the wastewater plant transportation were reasonable and do not indicate negligence.

Petitioner has shown good faith reliance on the advice of its accountant with respect to the choice of accounting method. Asphalt Products has shown that the advice of its accountant was based on all the facts and it is not liable for additions to tax on this account. *Conlorez Corp. v. Commissioner*, 51 T.C. 467 (1968); *Woodbury v. Commissioner*, 49 T.C. 180 (1967); see *Leonhart v. Commissioner*, 414 F.2d 749 (4th Cir. 1969), affg. a Memorandum Opinion of this Court. Petitioner has not established, however, that the expense of $1,103.04 with respect to the transportation of the plants was other than a personal expense of William and Clark and thus it is liable for the section 6653(a) addition to tax as a result of this adjustment.[26]

[25] As stated in footnote 3, *supra*, petitioner conceded that this amount, representing truckdriver salary of $399.51 and expense reimbursement of $703.53 was not properly deductible. Although on brief, petitioner states that this amount is, after all, properly deductible, justice does not require us to consider the stipulation to be without binding effect. See Rule 91(e).

[26] We have held that the deduction by a corporation of personal expenditures as business expenses is clearly negligence. *Finney v. Commissioner*, T.C. Memo. 1980-23.

Asphalt Products has stipulated to the nondeductibility of $1,103.04 in connection with the transportation of the plants from California to Tennessee. To the extent petitioners William and Clark in Docket Nos. 6759-78 and 6734-78, respectively, still maintain they are not taxable on the benefit received by them from their corporation, we find that they have each received constructive dividends in the amount of $551.52 as determined by respondent. See Rule 142(a).

Petitioners William and Clark on petition raise an issue in Docket Nos. 6717-77, 6729-77, 6734-78, and 6759-78 relating to the characterization of coal royalties paid as ordinary business deductions or as reductions of coal royalties received under sections 631 and 1231. Both petitioners and respondent agree that all stipulations of fact in *Davis v. Commissioner*, 74 T.C. 881 (1980), on appeal (6th Cir., Feb. 17, 1981; 9th Cir., Mar. 20, 1981), as that case relates to these common issues are to be taken as fact in this action. They had also agreed to be bound by the final determination of the Sixth Circuit Court of Appeals or the United States Supreme Court in *Davis* if a determination of the Sixth Circuit or the United States Supreme Court became final prior to this opinion. We conclude that *Davis v. Commissioner*, *supra*, controls petitioners' situation and we are bound by our decisions therein.

Due to concessions,

Decisions will be entered under Rule 155.

APPENDIX E

UNITED STATES TAX COURT

Docket No. 6758-78

ASPHALT PRODUCTS CO., INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

DECISION

Pursuant to the opinion of the Court filed April 24, 1984, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That there is a deficiency in income tax due from the petitioner for the taxable year 1974 in the amount of $133,248.69;

That there is an overpayment in income tax for the taxable year 1975 in the amount of $2,415.80, which amount was paid on March 15, 1976, and for which amount a claim for refund could have been filed, under the provisions of I.R.C. section 6511(b)(2), on March 23, 1978, the date of the mailing of the notice of deficiency;

That there is an addition to the tax due from the petitioner for the taxable year 1974, under the provisions of I.R.C. section 6653(a), in the amount of $6,943.37;

That there is no addition to the tax due from the petitioner for the taxable year 1975, under the provisions of I.R.C. section 6653(a).

(Signed) Leo H. Irwin
Judge

Entered: 27 Sep., 1984

* * * *

APPENDIX F

The Conference Report on the Tax Reform Act of 1986, H.R. Conf. Rep. 99-841, 99th Cong., 2d Sess. Vol. II 779-782, provided in pertinent part:

3. *Negligence and Fraud Penalties*

Present Law

Negligence

Taxpayers are subject to a penalty if any part of an underpayment of tax is due to negligence or intentional disregard of rules or regulations (but without intent to defraud) (Code sec. 6653(a)). There are two components to this penalty. The first component is 5 percent of the total underpayment, where any portion of the underpayment is attributable to negligence or intentional disregard of rules or regulations. Thus, if a taxpayer has underpaid $1,000 in taxes and the portion due to negligence is $200, the amount of the penalty is $50 (5 percent of $1,000). The second component is an amount equal to one-half the interest payable on the portion of the underpayment attributable to negligence or intentional disregard, for the period beginning on the last day prescribed for payment of the underpayment (without regard to any extension) and ending on the date of the assessment of the tax (or the date of payment of the tax, if that date is earlier).

Generally, once the IRS has determined that negligence existed, the burden is on the taxpayer to establish that the IRS' determination of negligence is erroneous. The taxpayer must meet a higher standard in the case of interest or dividend payments (sec. 6653(g)). This section provides that if the taxpayer fails to include in income an interest or dividend pay-

ment shown on an information return, the portion of the underpayment attributable to this failure is treated as due to negligence in the absence of clear and convincing evidence to the contrary. The effect of this provision is that the IRS may automatically assert the negligence penalty in these circumstances, and the taxpayer must present clear and convincing evidence that no negligence was involved in order to avoid the penalty.

The negligence penalty applies only to underpayments of income taxes, gift taxes, and the windfall profits tax.

Fraud

Taxpayers are also subject to a penalty if any part of an underpayment of tax is due to fraud (sec. 6653 (b)). This penalty is in lieu of the negligence penalty. There are two components to the fraud penalty. The first component is 50 percent of the total underpayment, where any portion of the underpayment is attributable to fraud. Thus, if a taxpayer has underpaid $1,000 in taxes and the portion due to fraud is $500, this component of the penalty is $500 (50 percent of $1,000). The second component is an amount equal to one-half the interest payable on the portion of the underpayment attributable to fraud, for the period beginning on the last day prescribed for payment of the underpayment (without regard to any extension) and ending on the date of the assessment of the tax (or the date of payment of the tax, if that date is earlier). The burden of proof is on the IRS to establish that fraud existed (sec. 7454(a)) with respect to an item on the taxpayer's return.

House Bill

Negligence

The House bill expands the scope of the negligence penalty by making it applicable to all taxes under the Code. The bill also generally redrafts the negligence penalty to make it clearer and more comprehensible. One element of that redrafting involves the provision of a definition of negligence. The bill includes within the scope of the definition of negligence both any failure to make a reasonable attempt to comply with the provisions of the Code as well as any careless, reckless, or intentional disregard of rules or regulations. The bill does not however, limit the definition of negligence to these items only. Thus, all behavior that is considered negligent under present law will remain within the scope of this negligence penalty. Also, any behavior that is considered negligent by the courts but that is not specifically included within this definition is also subject to this penalty.

The House bill also expands the scope of the special negligence penalty that is currently applicable to failures to include in income interest and dividends shown on an information return. The bill expands this provision so that it is applicable to failures to show properly on the taxpayer's tax return any amount that is shown on any information return. This penalty applies to the same information returns that are subject to the penalties for failure to provide information returns. Thus, if a taxpayer fails to show properly on the taxpayer's tax return any amount that is shown on an information return, the taxpayer's failure is treated as negligence in the absence of clear and convincing evidence to the contrary.

Fraud

The House bill modifies the fraud penalty by increasing the rate of the penalty but at the same time narrowing its scope. First, the bill increases the rate of the basic fraud penalty from 50 to 75 percent. (The time-sensitive component of the fraud penalty is not altered.) Second, the scope of the fraud penalty is reduced so that in effect it applies only to the amount of the underpayment attributable to fraud (this is essentially the same amount to which the present-law time-sensitive component of the fraud penalty applies). The bill does this by providing that, once the IRS has established that any portion of an underpayment is attributable to fraud, the entire underpayment is treated as attributable to fraud, except to the extent that the taxpayer establishes that any portion of the underpayment is not attributable to fraud. This is done so that, once the IRS has initially established that fraud occurred, the taxpayer then bears the burden of proof to establish the portion of the underpayment that is not attributable to fraud. The fraud penalty is determined at the top marginal rate applicable to the taxpayer.

These modifications to the fraud penalty do not affect the statute of limitations for false or fraudulent returns (sec. 6501(c)). Thus, if a taxpayer files a return that is in some respects fraudulent, the statute of limitations with respect to the entire return never expires.

Interaction of negligence and fraud penalties

If an underpayment of tax is partially attributable to negligence and partially attributable to fraud, the

negligence penalty (which generally applies to the entire underpayment of tax) does not apply to any portion of the underpayment with respect to which a fraud penalty is imposed.

The amendments to the negligence and fraud penalties are applicable to returns the due date of which (determined without regard to extensions) is after December 31, 1985.

Senate Amendment

The Senate amendment is the same as the House bill. In addition, the Senate amendment modifies the negligence penalty by increasing the rate of the penalty but at the same time narrowing its scope. First, the bill increases the rate of the negligence penalty from 5 to 10 percent. (The time-sensitive component of the negligence penalty is not altered.) Second, the scope of the negligence penalty is reduced so that in effect it applies only to the amount of the underpayment attributable to negligence (this is the same amount to which the present-law time-sensitive component of the negligence penalty applies). The negligence penalty is determined at the top marginal rate applicable to the taxpayer.

The amendments to the negligence and fraud penalties are applicable to returns the due date of which (determined without regard to extensions) is after December 31, 1986.

Conference Agreement

The conference agreement follows the Senate amendment, except that it does not increase the rate of the negligence penalty or apply it only to the portion of the underpayment attributable to negligence.

Instead, the conference agreement maintains the 5-percent rate of present law, and the present-law application of that penalty to the entire amount of the underpayment, not just to the portion of the underpayment attributable to negligence.[3]

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[3] In a recent case, the Sixth Circuit held that the negligence penalty "should be applied only to that portion of the deficiency attributable to [the negligent action]." (*Asphalt Products Co. v. Comm'r*, Nos. 84-1841, 84-1882 slip op. (6th Cir. July 17, 1986)). The conference agreement provides that the negligence penalty applies (once one element of negligence has been demonstrated) to the entire underpayment, not just to the portion attributable to negligence. The conference agreement is, with respect to this issue, a continuation of the rule of present law, which also provides that the negligence penalty applies to the entire underpayment, not just to the portion attributable to negligence. The conferees note that this case both inaccurately states present law and is in any event of no effect under the conference agreement.

APPENDIX G

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 6653. FAILURE TO PAY TAX.

(a) Negligence or Intentional Disregard of Rules and Regulations With Respect to Income or Gift Taxes.—If any part of any underpayment (as defined in subsection (c)(1) of any tax imposed by subtitle A or by chapter 12 of subtitle B (relating to income taxes and gift taxes) is due to negligence or intentional disregard of rules and regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5 percent of the underpayment.

(b) Fraud.—If any part of any underpayment (as defined in subsection (c)) of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 50 percent of the underpayment. In the case of income taxes and gift taxes, this amount shall be in lieu of any amount determined under subsection (a). In the case of a joint return under section 6013, this subsection shall not apply with respect to the tax of a spouse unless some part of the underpayment is due to the fraud of such spouse.

(c) Definition of Underpayment.—For purposes of this section, the term "underpayment" means—

(1) Income, estate, gift, and certain excise taxes.—In the case of a tax to which section 6211 (relating to income, estate, gift, and certain excise taxes) is applicable, a deficiency as defined in that section (except

that, for this purpose, the tax shown on a return referred to in section 6211(a)(1)(A) shall be taken into account only if such return was filed on or before the last day prescribed for the filing of such return, determined with regard to any extension of time for such filing), and

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